

## On X Holding and the Court of Justice's Ambiguous Approach towards the Proportionality Test

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### 1 Introduction

On February 25, 2010, the Court of Justice rendered its decision in the X Holding case.<sup>2</sup> The Court ruled that the Dutch tax consolidation regime is compatible with the freedom of establishment. The territoriality principle justifies the limitations on the regime's scope of application in an intra-EU context. With its ruling, the Court basically followed the opinion of Advocate General (hereinafter: 'AG') Kokott, she delivered on November 19, 2009. Kokott advocated the position that the Dutch tax consolidation regime may generally be regarded as being compatible with the freedom of establishment (at least to the extent that it entails that an aggregation of current business profits and losses realized by resident and non-resident group companies is impossible). Accordingly, today, it seems clear that the Dutch tax consolidation regime in its current design may be kept in place. However, the Court of Justice did not provide a clear answer to the underlying question of how the proportionality test should be interpreted under primary EU law where EU Member States (hereinafter: 'EU MSs') raise the territoriality principle as a justification for an obstacle imposed. In this article, I address the question of how the proportionality test should be interpreted in this respect.

### 2 Interpretation of the freedom of establishment is *in abstracto* clear, but *in concreto* indistinct

On December 1, 2009, the Lisbon Treaty (Treaty on European Union and the Treaty on the Functioning of the European Union (the latter hereinafter referred to as: 'TFEU')) entered into force. The Lisbon Treaty expresses the EU MSs' objective of establishing a common market without internal frontiers on the basis of common social and economic policies ensuring fair (equitable) and free (economically efficient) competition.<sup>3</sup> This entails that all distortions of the common market need to be eliminated. Amongst other things, this requires the abolition of all obstacles to intra-EU movements of goods, services, persons and capital (the free movements or fundamental freedoms).<sup>4</sup>

The freedom of persons comprises the freedom of establishment. The freedom of establishment guarantees that economic operators, which have established themselves within EU territory and make use of the freedom of establishment (i.e. set up a business enterprise in another EU MS), can move their business activities freely between the respective domestic

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<sup>2</sup> Court of Justice, case C-337/08 (X Holding). See for comparison Opinion of AG Kokott of 19 November 2009 in case C-337/08 (X Holding). The question of the (in)compatibility of Dutch tax consolidation regime with primary EU law has been regularly addressed in tax literature. Reference can be made to D.M. Weber, *Refusal of advantages of a cross-border tax consolidation in some situations an unjustified restriction of the freedom of establishment*, Highlights and Insights on European Taxation 2010/1.6, F.A. Engelen, *De gevolgen van de zaak Papillon voor de Nederlandse fiscale eenheid*, NTFR 2009/73, W.F.E.M. Egelie, *De zaak Papillon, typisch Frans?*, NTFR Beschouwingen 2009/12, Q.W.J.C.H. Kok, *De grensoverschrijdende fiscale eenheid in de vennootschapsbelasting*, WFR 2008/795, S. van Weeghel, *Verliesverrekening over de grens – de vrijstellingsmethode ingekaderd*, WFR 2005/744, D.M. Weber, *Vpb. 2007. Opruimen van EG-rechtelijke knelpunten*, WFR 2004/1251, B.J. Kiekebeld, *Is het nieuwe regime fiscale eenheid binnen EU-verband te sterk begrensd?*, WFR 2001/1621, C. van Raad, *Grensoverschrijdende fiscale eenheden: hoe ver reikt de bescherming van non-discriminatiegeboden?*, WFR 1994/1717, P.Q.M. Van Dijk en A.G. Goedkoop, *Hoe ver reikt de horizon van de fiscale eenheid in EG verband?*, FED 1994/375, M.D. Bosch, *De nieuwe fiscale eenheid: EU-proof?*, MBB 2000/335.

<sup>3</sup> Article 2 Treaty on European Union (hereinafter: 'TEU') in conjunction with Articles 26 and 119 Treaty on the Functioning of the European Union (hereinafter: 'TFEU'). Cf. Court of Justice case 15/81 (Gaston Schul).

<sup>4</sup> The harmonization of EU law in the field of direct taxation for the purpose of removing disparities (i.e. mutual divergences between the international tax systems of EU Member States (hereinafter: 'EU MSs')) will be left out of consideration.

markets of the EU MSs (the ‘market access’ or ‘market neutrality principle’).<sup>5</sup> In addition to this, all economic operators that have their place of residence in the EU and make use of one of the free movements may rely on being subject to the same national tax rules for market participation in the domestic markets of the respective EU MSs, irrespective of their place of residence (the ‘market equality principle’).<sup>6</sup> Accordingly, scenarios that are comparable from a (business) economics perspective deserve the same tax treatment in an EU MS irrespective of the economic operator’s place of residence and irrespective of whether that economic operator performs its economic activities spread out across various EU MSs.

In the event that EU MSs encroach upon these principles by unilaterally imposing distortions of the internal market (‘obstacles’), these EU MSs infringe the fundamental freedoms. On the basis of established case law of the Court of Justice, obstacles imposed by EU MSs are incompatible with EU law, unless they are capable of being justified by overriding reasons in the general interest. As a justification, the Court of Justice accepts the so-called territoriality principle (in conjunction with anti-tax abuse considerations). As I see it, the territoriality principle essentially entails that EU MSs are allowed to keep foreign source income items outside their domestic tax base.<sup>7</sup> This is for the purpose of preserving a balanced allocation of taxing powers between the EU MSs. But also for the purpose of avoiding double-dip risks (i.e. the risk that losses are set off twice) and countering tax avoidance within the EU. From the objective of pursuing a common market without internal frontiers it may be derived that EU MSs are not allowed to unilaterally impose market distortions with respect to economic operators crossing their tax borders. Accordingly, when expressing the territoriality principle in their international tax systems, the EU MSs are required to do this in a manner that distorts the functioning of the internal market as little as possible (the proportionality test). This entails that the expression of the territoriality principle in an EU MS’s international tax system needs to (1) be suitable to attain the objective of keeping foreign income outside the domestic tax base (effective), yet (2) not go beyond what is necessary to obtain that objective (efficient).

The aim of pursuing a common market without internal frontiers requires that all economic operators which have established themselves within EU territory and which are liable to corporate taxation in an EU MS have the right to an equal corporate tax treatment in that respective EU MS.<sup>8</sup> In an internal market the way the investment is directed – i.e. inbound (capital import), or outbound (capital export) – should be irrelevant. In addition to this, EU MSs are prohibited from unilaterally distorting the economic operator’s choice of legal form.<sup>9</sup>

*In abstracto*, this boils down to the following norm: in scenarios where the TFEU applies, EU MSs should ensure that the domestic tax burden on the income realized out of the cross-border (i.e. intra-EU) business activities of taxpayers should be equal to the domestic tax burden

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<sup>5</sup> See for comparison B.J.M Terra and P.J. Wattel, *European Tax Law*, Fifth Edition, Fiscale Studiereserie nr. 29, Kluwer Deventer, 2008, at p. 28, as well as Frans Vanistendael (ed.), *EU Freedoms and Taxation*, EALTP International Tax Series, Vol. 2, IBFD 2004, Amsterdam at p. 106-107, and Frans Vanistendael, *In Defence of the European Court of Justice*, 2008 Bulletin for International Taxation 90, p. 96. The same may be true for residents of non-Member States in the event that the EU has concluded an association agreement with that state containing provisions (with direct effect) dealing with free movements of goods, services, persons and capital.

<sup>6</sup> Cf. Vanistendael, *supra* note 5, at p. 90-98. See also Vanistendael (ed.), *supra* note 5, at p. 106-107. The same may be true for residents of non-Member States in the event that the EU has concluded an association agreement with that state containing provisions (with direct effect) dealing with free movements of goods, services, persons and capital.

<sup>7</sup> The Court of Justice has put this into words in case C-414/06 (Lidl) as the “need to preserve the allocation of the power to impose taxes between the Member States concerned (...) and to prevent the danger that losses may be taken into account twice”. Moreover, in Court of Justice case C-446/03 (Marks & Spencer II), the Court of Justice referred to a ground for justification founded on anti-tax abuse considerations, i.e. the “risk of tax avoidance”. Cf. Court of Justice cases C-293/06 (Deutsche Shell), C-231/05 (Oy AA) and Court of Justice case C-157/07 (Krankenheilm). Other grounds for justification are the need to guarantee the effectiveness of fiscal supervision in situations falling outside the scope of application of the Mutual Assistance Directive (77/799/EEC): see Court of Justice cases C-101/05 (Swedish A) and C-446/04 (FII), as well as anti-tax abuse considerations in situations where wholly artificial arrangements are set up with the purpose of “circumventing the application of the legislation of the Member State concerned” (see Court of Justice cases C-196/04 (Cadbury), C-425/06 (Part Service) and Opinion of AG Mengozzi in Court of Justice case C-298/05 (Columbus).

<sup>8</sup> See Court of Justice case C-170/05 (Denkavit Internationaal).

<sup>9</sup> See Court of Justice case 270/83 (Avoir Fiscal), Columbus, *supra* note 7 and the Opinion of AG Maduro in Marks & Spencer II, *supra* note 7. See also Court of Justice cases C-307/97 (Saint Gobain), C-311/97 (RBS) and 270/83 (Commission/France).

on the income realized out of the non-cross-border (i.e. purely domestic) business activities of taxpayers. In the event that the tax burden differs, that EU MS (in abstracto) infringes EU law by unilaterally imposing an obstacle. Namely, in that case, the difference in the tax burden can necessarily only be caused by:

- the taxpayer's place of residence (infringement of the 'market equality principle') or;
- the fact that the taxpayer conducts its business activities spread across various EU MSs (infringement of the 'market access principle').

However, *in concreto*, this norm cannot be unambiguously derived from the case law of the Court of Justice in the field of direct taxation. This is caused by the fact that the Court of Justice does not interpret the fundamental freedoms – and in particular the proportionality test – in a consistent manner. The Court of Justice does not provide an answer to the question whether the proportionality test requires EU MSs to develop an economically efficient international tax system, or allows EU MSs some leeway in maintaining the obstacles in their tax systems. Due to the Court of Justice's ambivalent approach in that respect, it is currently indistinct whether EU MSs have a margin in deciding on the manner in which they keep their taxpayers' foreign income items outside their domestic tax bases.

This lack of clarity in primary EU law as it currently stands becomes evident when the Dutch tax consolidation regime is analyzed as to its compatibility with the freedom of establishment. An analysis of the Court of Justice's case law available prior to the rendering of the Court's decision in the X Holding case reveals that there are rulings available on the basis of which the Dutch tax consolidation regime could be considered both compatible ("*door A*"; see section 4.1) and incompatible ("*door B*"; see section 4.2) with the freedom of establishment. Unfortunately, the Court of Justice did not fully appreciate this in its ruling in the X Holding case. In its answer to the Dutch Supreme Court's question on the compatibility of the Dutch tax consolidation regime, the Court of Justice chose "*door A*" and ruled the regime incompatible with EU law. But why? Why did the Court not pick "*door B*" and ruled that the Dutch tax consolidation regime is incompatible with EU law? Regrettably, in its ruling in the X Holding case, the Court of Justice neither explains us its underlying reasons for taking apparently divergent approaches in its earlier case law, nor explains us why it favored "*door A*" over "*door B*". I will try to illustrate this in more detail in the following sections.

### **3 Dutch tax consolidation regime *in abstracto* incompatible with the freedom of establishment**

Before leaping to the consequences of the Court of Justice's murky approach towards the proportionality test under the fundamental freedoms, I would first like to devote a few words to the distorting manner in which the Dutch tax consolidation regime functions in a cross-border context. As in most international corporate tax systems of states, the Dutch Corporate Income Tax Act (hereinafter: 'Dutch CITA') taxes corporate entities on an individual basis (the separate entity approach). This legally-oriented approach is maintained in the event that these entities belong to a group.<sup>10</sup>

A comparison between a group of affiliated corporate entities operating a business enterprise and a single corporate entity operating a business enterprise reveals that the separate entity approach leads to different corporate tax treatment in comparable circumstances. Transactions between corporate affiliates ('intra-group transactions') are recognized as a taxable event for corporate tax purposes. Consequently, an at arm's length transfer price needs to be determined with respect to intra-group provisions of services and supplies of goods. This is not the case with dealings between the branches of a single corporate entity ('internal dealings'). In addition to this, an aggregation of the group's business income (i.e. an aggregation of losses and profits realized by the various affiliates within the tax year) is denied, while an aggregation of the business income realized by the single corporate entity's branches is granted. Due to this, groups are put at a competitive disadvantage as the different tax treatment in comparison with single

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<sup>10</sup> In my view, one may speak of a group in the event that the business activities of the aggregate of corporate entities are integrated financially, economically and organizationally into one business enterprise. In that event, the aggregate of corporate entities constitutes one economic operator, i.e. the group, conducting an integrated business enterprise.

entities leads to liquidity (cash flow) disadvantages and the economic double taxation of business income realized by the group. Accordingly, the separate entity approach distorts the decisions of an economic operator in which it arranges its business affairs legally.<sup>11</sup>

In the Netherlands, these distortive features of the separate entity approach are remedied in scenarios where the Dutch tax consolidation regime applies.<sup>12</sup> In order to acknowledge the business economics reality of the group acting as the economic operator (or economic entity) for corporate tax purposes (the unitary business approach), the group is treated as a single taxpayer under the Dutch CITA (upon request). The ultimate parent company is regarded as the taxable unit; its subsidiaries are transparent ('piercing the corporate veil'). As a result of this, the group of affiliated corporate entities receives the exact same corporate tax treatment as a single corporate entity (taxpayer) that is conducting its business enterprise through branches. Tax consolidation entails economic single taxation in an economically efficient manner (i.e. an aggregation of profits and losses realized by the various affiliates and the elimination of intra-group transactions for corporate tax purposes).<sup>13</sup> Notably, I would like to stress here that tax consolidation *remedies* distortions imposed. Accordingly, tax consolidation should *not* be considered as a mechanism providing *benefits or advantages* to corporate taxpayers. To my impression the Court of Justice does not fully appreciate this, as it explicitly refers to the tax consolidation as providing corporate groups an advantage.<sup>14</sup>

In general, the application of the tax consolidation regime is only allowed in scenarios to the extent that the string of affiliated corporate entities has its corporate tax residence within the Netherlands.<sup>15</sup> With respect to group companies that have their residence for corporate tax purposes outside Dutch territory, tax consolidation is only possible under the so-called "PE variant", i.e. to the extent that these companies operate a business in the Netherlands through a permanent establishment (hereinafter: 'PE'). Moreover, the shareholders' interest of that foreign group company in the underlying group company needs to be attributable to the PE's business capital (on the basis of a functional and factual analysis).

The application of the Dutch tax consolidation regime entails that the tax burden in the Netherlands on the group's business income is the same in each of the following scenarios:

- a) a single corporate entity, a Dutch resident corporate taxpayer, conducts its business activities solely in the Netherlands;
- b) a single corporate entity, a Dutch resident corporate taxpayer, conducts its business activities spread out across the Netherlands and one or more other states, and the Netherlands grants double tax relief with respect to the foreign business income realized by applying the tax exemption methodology;
- c) the entire string of affiliated corporate entities have their corporate tax residence within the Netherlands, tax consolidation is applied, and the group of affiliated companies conduct their business activities solely in the Netherlands;
- d) the entire string of affiliated corporate entities have their corporate tax residence within the Netherlands, tax consolidation is applied, the group of affiliated companies conduct their business activities spread out across the Netherlands and one or more other states, and the Netherlands grants double tax relief with respect to the foreign business income realized by applying the tax exemption methodology.

The taxpayer's decision on whether or not to conduct its business activities abroad is not distorted by the Dutch corporate income tax levied. This is due to the fact that the Netherlands grants double tax relief with respect to foreign source income by applying the tax exemption

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<sup>11</sup> The income taxation of individuals and the coherence between the Dutch corporate income tax and individual income tax legislation is left out of consideration.

<sup>12</sup> See Article 15 Dutch Corporate Income Tax Act (hereinafter: 'Dutch CITA').

<sup>13</sup> It should be noted that in respect of proceeds from shareholding interests in group companies, single taxation is also achieved on the basis of the Dutch participation exemption and the dividend withholding tax exemption regimes (or the application of a 0% rate on outbound dividend distributions). These regimes will be left out of consideration. The concurrent effects of these regimes with the tax consolidation regime are left out of consideration as well.

<sup>14</sup> The Court of Justice does not fully appreciate this in X Holding, *supra* note 2, at observation 18.

<sup>15</sup> See Article 15 Dutch CITA. In addition to this, tax consolidation is subject to the requirement that the (ultimate) parent company (in)directly holds a shareholding interest in its (sub-)subsidiaries of at least 95%. The question of whether the 95% criterion adequately expresses the unitary business approach is left out of consideration.

methodology in the (cross-border) scenarios b) and d). The tax exemption is a tax-neutral double-tax relief mechanism: it keeps foreign income items outside the Dutch corporate tax base in an economically efficient manner. Moreover, income realized within Dutch tax territory is being taxed in an unimpaired manner. For a proper understanding of how the methodology functions, I would like to devote some words to its mechanics as currently applied in the Netherlands.<sup>16</sup> With respect to PEs, the separate entity approach is applied in the Netherlands as well: PEs are hypothesized as distinct and separate enterprises. However, the tax exemption methodology adequately rectifies the aforementioned distorting effects that the adoption of the separate entity approach entails. The Netherlands allows its resident taxpayers to include negative income items from foreign sources in the domestic tax base. The Netherlands reserves the right to include foreign source income items (both positive and negative) in the domestic tax base in the bilateral double tax conventions that the Netherlands has concluded ('tax base reservation', in Dutch: 'grondslagvoorbehoud'). Subsequently, the Netherlands provides for double tax relief with respect to the foreign income items that are included in the Dutch worldwide tax base ('tax base requirement', in Dutch: 'grondslageis'). The tax relief methodology is generally referred to as 'tax exemption' but basically functions as a 'credit for the domestic tax that is attributable to foreign income'. The relief is determined by making reference to the same fraction as generally applied under the second limitation in the ordinary credit methodology as commonly applied in the field of international taxation. Double-loss compensation ("double dipping") is prevented on the basis of the so-called 'recapture of foreign losses method' (in Dutch: 'inhaalregeling') and the 'carry forward of foreign profits method' (in Dutch: 'doorschuifregeling'). Moreover, under the tax exemption methodology, latent corporate tax claims on hidden reserves do not become immediately due when capital assets are transferred from Dutch territory to abroad. Instead, substantially, the hidden reserve is added to the domestic taxable base in yearly instalments, which vary directly proportional to the annual depreciation terms during the remaining economic lifetime of the transferred asset.<sup>17</sup> In the event that the foreign business income of the group (or the single entity / corporate taxpayer) has been realized in a state with which the Netherlands has not concluded a double tax convention, single taxation is guaranteed as the granting of double tax relief is preceded by a 'subject to tax requirement' (in Dutch: 'onderworpenheidseis'). Accordingly, the tax exemption mechanism preserves a balanced allocation of taxing powers in an equitable and economic efficient manner. Neither double dip-risks nor tax avoidance possibilities appear.

Denying the application of the Dutch tax consolidation regime under the aforementioned criteria entails that the following scenarios are impossible:

1. tax consolidation of Dutch parent companies with Dutch sub-subsidiaries (group companies) in the event that the intermediate shareholding company:
  - o has its tax residency outside Dutch territory; and
  - o does not conduct business in the Netherlands through a PE to which the shareholders' interest in the underlying Dutch group company is attributable;
2. tax consolidation of same tier Dutch group companies (hereinafter: 'sister companies') with their mutual (ultimate) parent company in the event that this parent company:
  - o has its tax residency outside Dutch territory; and
  - o does not conduct business in the Netherlands through a PE to which the shareholders' interest in the underlying Dutch group companies (sister companies) is attributable;

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<sup>16</sup> For a more detailed description of the methodology see Maarten F. de Wilde, *Some Thoughts on a Fair Allocation of Corporate Tax in a Globalizing Economy*, to be published in Intertax in May 2010, section 7.1.

<sup>17</sup> Technically, this works as follows. The assets transferred from the Dutch head office to the foreign PE are placed on the PE's balance sheet at fair value rather than the (lower) fiscal bookkeeping value. Subsequently, for the purpose of determining the PE's tax exempt profit, the annual (tax deductible) depreciation term is calculated against that fair value (instead of the fiscal bookkeeping value). Accordingly, this leads to an annual reduction of the tax exempt PE income for a period that corresponds with the remaining economic lifetime of the respective transferred asset. And this leads to an increase of the corporate tax annually payable at the level of the head office during that same period. See HR, February 12, 1964, BNB 1964/95 (Hopperzuiger).

3. tax consolidation of a non-Dutch tax resident parent company or subsidiary (foreign group companies) without a PE in the Netherlands to which the shareholders' interest is attributable.

In scenarios 1 to 3, the application of the Dutch tax consolidation regime is disallowed with respect to foreign source business income to the extent that the group of affiliated corporate entities conducts its business activities through non-Dutch tax resident companies. The foreign source business income is kept outside the Dutch corporate tax base.<sup>18</sup> Substantially, the foreign source business income is kept outside Dutch corporate taxation through a 'base exemption'. Under the base exemption, the market distortions imposed under the separate entity approach are maintained: (liquidity) disadvantages emerge due to the recognition of intra-group transactions for corporate tax purposes (e.g. imposition of exit taxes on cross-border intra-group asset transfers) and non-aggregation of business profits and losses.<sup>19</sup> Single taxation is not achieved in a tax efficient manner. Notably, the market distortions imposed accordingly, are not rectified under the application of the supplementary Dutch tax regime which allows for a deduction of losses realized at the level of a shareholding company upon the liquidation of a non-consolidated (foreign) subsidiary (the 'liquidation losses set-off regime', in Dutch: 'liquidatieverliesregeling'): liquidity disadvantages with regard to non-definitive losses realized out of cross-border business activities are maintained.

Scenario d), where tax consolidation is allowed, also deals with business income realized outside Dutch territory. The only difference with scenarios 1 to 3 is that the group operates its foreign business activities in scenario d) through an affiliate that qualifies as a resident taxpayer for corporate income tax purposes. In scenario d), foreign business income is kept outside Dutch corporate taxation as well. However, contrary to scenarios 1 to 3 ('base exemption'), single taxation is achieved through the application of the tax-neutral 'tax exemption' methodology.

The limited scope of application of the Dutch tax consolidation regime entails that the business activities of multinational enterprises are subject to a different tax burden (tax exemption in scenarios a) and d); base exemption in scenarios 1 to 3).<sup>20</sup> Despite the fact that all scenarios (i.e. scenarios a) to d) and 1 to 3) are comparable from a business economics perspective. Consequently, in scenarios 1 to 3, the Dutch tax legislation distorts the decision of groups of companies paying corporate tax in the Netherlands as to whether or not to conduct business activities outside the Netherlands. The differences in the corporate tax burden in the Netherlands are caused by:

- the place of residence of the respective group companies, or;
- the fact that the business activities are performed across various states.

To the extent that it concerns the application of the Dutch tax consolidation regime with respect to group companies that have their tax residence within the EU, the regime falls within the scope of application of the TFEU.<sup>21</sup> The consequence of this is that the Netherlands in scenarios 1 to 3 unilaterally distorts the functioning of the internal market without internal frontiers. By refusing tax consolidation in these scenarios, the Netherlands maintains the distortive features of the separate entity approach with respect to intra-EU business activities (establishments). This is merely due to the place of tax residence of the corporate entities involved or the fact that the

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<sup>18</sup> Corporate entities having their tax residence outside the Netherlands without having a permanent establishment (PE) situated in the Netherlands are kept outside corporate taxation in the Netherlands completely. Corporate entities having their tax residence outside the Netherlands with a PE situated in the Netherlands are kept outside corporate taxation to the extent that they have realized their business income outside Dutch territory. See for comparison the rulings of the Dutch Supreme Court (in Dutch: Hoge Raad, hereinafter: 'HR') of February 17, BNB 1994/163 (Irish dual resident) and March 12, 1980, BNB 1980/170 (Frontier worker).

<sup>19</sup> It should be noted that this holds true with the exception of proceeds from shareholding interests in group companies. With respect to these proceeds, single taxation is achieved on the basis of the Dutch participation exemption and the dividend withholding tax exemption regimes (or the application of a 0% rate on outbound dividend distributions).

<sup>20</sup> Reference can be made to comparisons by the Court of Justice in cases C-410/98 (*Metallgesellschaft and Hoechst*), *Marks & Spencer II*, *supra* note 7, *Oy AA*, *supra* note 7, *Columbus*, *supra* note 7 and *Lidl*, *supra* note 7.

<sup>21</sup> Scenarios where the group companies involved have their place of tax residence outside EU territory (third-country scenarios), seem to fall outside the scope of application of the TFEU. See Court of Justice case C-284/06 (*Burda*) and HR September 26, 2008, BNB 2009/24, V-N 2008/47.13. From his case law it may be derived that majority shareholding interests need to be reviewed under the freedom of establishment. This freedom does not have third-country effect. Cf. AG Kokott, *supra* note 2, in this respect.

group conducts its business activities in an intra-EU context. By denying the application of the tax consolidation regime in scenarios 1 to 3, the Netherlands taxes business income realized out of intra-EU establishments differently in comparison with business income realized out of comparable (non-intra-EU) establishments a) to d). Consequently, the Netherlands unilaterally makes intra-EU business activities of groups less attractive. This distorts the functioning of the internal market and accordingly results in an obstacle. Therefore, the current tax consolidation regime infringes the freedom of establishment *in abstracto*.

The concept of the internal market without frontiers requires the Netherlands to apply the tax consolidation regime (*in jure*) to group companies (i.e. both parent companies as well as subsidiaries) that have their place of residence within the EU (cross-border tax consolidation).<sup>22</sup> By analogy to the tax treatment of a single corporate entity with business income realized out of foreign (i.e. intra-EU) business activities, the equitable and economically efficient tax exemption methodology would subsequently apply with respect to the group's foreign business income. The application of this double tax relief method could be preceded by a subject to tax clause for the purpose of countering tax avoidance. Such an approach would acknowledge the business economics reality of the group as one economic operator. Moreover, foreign business income items would effectively be kept outside the domestic corporate tax base. The territoriality principle would be appreciated accordingly. Furthermore, the economic operator's (i.e. the group's) decision as to whether or not to conduct its business activities abroad would not be distorted by the Dutch corporate income tax levied. Accordingly, the proportionality test would be appreciated as well.

In effect, the consequence would be that the consolidated foreign resident group companies (subsidiaries) would (materially) become transparent for Dutch corporate income tax purposes. Consequently, the subsidiaries' businesses would be regarded as constituting branches ('PEs') of the (ultimate) parent company.<sup>23</sup> Foreign resident (ultimate) parent companies would become subject to an unlimited corporate income tax liability with respect to their Dutch resident transparent (sub-)subsidiaries. Single taxation would be guaranteed under the tax exemption methodology. This would have been the consequence should the Court of Justice ruled the Dutch tax consolidation regime incompatible with EU law in the X Holding case. Unfortunately, the Court of Justice did otherwise.

#### **4 Available lines of reasoning on the (in)compatibility of the Dutch tax consolidation regime with the freedom of establishment**

##### **4.1 "Door A": In concreto compatible: "effective and therefore proportional"**

As mentioned in section 2 in the above, there are (at least) two lines of reasoning available in the Court of Justice's case law on the basis of which the Dutch tax consolidation regime could be considered both compatible and incompatible with the freedom of establishment. Curious but true: there is sufficient case law available to support opposite conclusions. In the following 2 subsections, I will address the available lines of reasoning. Let us first deal with the line of reasoning the Court of Justice adopted in the X Holding case.

"Door A": the compatibility of the Dutch tax consolidation regime with the freedom of establishment. This position can be based on the rulings of the Court of Justice in the Lidl and Marks & Spencer II cases.<sup>24</sup> The key element in the required reasoning is the assumption that EU MSs are entitled to keep foreign income items *effectively* out of their domestic tax bases. EU MSs are permitted to counter the double dip risk (the risk that the same losses are taken into account

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<sup>22</sup> In my view, tax consolidation *in jure* is necessary to avoid arbitrary outcomes.

<sup>23</sup> There is already some experience with the technical consequences of applying a cross-border tax consolidation in the Netherlands as the former (pre 2003) tax consolidation regime – to a certain extent – allowed for the consolidation of non-Dutch tax resident companies (consolidation of non-Dutch resident companies was possible, subject to the provision that these companies were incorporated under Dutch company law). In this respect, reference can be made to HR March 16 1994, BNB 1994/191, HR June 29, 1988, BNB 1988/331 and HR November 13, 1996, BNB 1998/47. See for comparison HR, May 24, 2002, BNB 2002/320.

<sup>24</sup> See Lidl, *supra* note 7 and Marks & Spencer II, *supra* note 7. See for comparison Kok, *supra* note 2 at section 3 and Kiekebeld, *supra* note 2.

twice, i.e. in two EU MSs simultaneously or successively). Just as the Dutch tax consolidation regime, in its current design, effectively counters this risk, the regime would be sufficiently proportional. This assumption lies at the heart of both the reasoning of AG Kokott in her Opinion and the reasoning as adopted by the Court of Justice in its ruling in the X Holding case.

With respect to the scenario of the intermediate shareholding company (section 3, scenario 1), Egelie was the first to submit the relevant argumentation in an attempt to counter-balance positions taken in Dutch tax literature on the incompatibility of the Dutch tax consolidation regime subsequent to the ruling of the Court of Justice in the Papillon case.<sup>25</sup> First, he takes the position that the Papillon case of the Court of Justice cannot be applied by way of analogy to the Dutch tax consolidation regime. In the Papillon case, the Court of Justice considered it incompatible with the freedom of establishment that the French tax consolidation regime did not allow for the consolidation of a French parent company with a French sub-subsidiary in the event that the intermediate shareholding company had its place of residence in an EU MS other than France.<sup>26</sup> The Court of Justice did not see any reason why the consolidation of French corporate entities should not be allowed. Namely, the French tax legislator had the opportunity to guarantee that the foreign business income of the group was kept outside the French tax base through lesser restricting measures. According to the Court of Justice, France could apply the tax consolidation, for example subject to the obligation of the group to provide information with respect to its foreign business activities.<sup>27</sup>

Egelie finds his view that the ruling of the Court of Justice in the Papillon case cannot be transposed into the Dutch case by analogy by pointing out the differences between the French and the Dutch regime. The mutual divergences are too significant for this. Contrary to the French regime, the Dutch tax consolidation regime opens the possibility to consolidate foreign intermediate shareholding companies. This is possible, subject to the requirement that a) the intermediate company conducts business in the Netherlands through a PE b) to which the shareholders' interest in the underlying Dutch group company is attributable (commonly referred to as the "PE variant" for which a "double test" applies). The "PE variant" is also referred to in section 3. Moreover, the Netherlands, contrary to France, provides for a deduction of losses realized at the level of a shareholding company upon the liquidation of a non-consolidated (foreign) subsidiary (under the 'liquidatieverliesregeling' (liquidation losses set-off regime')). Because the Dutch tax consolidation entails that the shareholding in a consolidated subsidiary is 'eliminated' (or derecognized) for corporate tax purposes, it will be impossible to deduct a liquidation loss upon the liquidation of that subsidiary under the Dutch liquidation losses set-off regime at the level of the shareholding company. This prevents taking the same (underlying) business loss realized within the string of consolidated group companies into account more than once (i.e. once at the level of the ultimate parent company as a regular business loss and then again upon the liquidation of the subsidiary as a liquidation loss). The risk of taking a business loss into account twice cannot be adequately prevented in the event that the Netherlands is required to allow the consolidation of the Dutch resident group companies (parent company with sub-subsidiary) in a manner as suggested by the Court of Justice in the Papillon case (i.e. without consolidating the foreign intermediate shareholding company as in scenario 3, referred to in section 3) in case the intermediate company does not have a PE in the Netherlands to which the shares in the sub-subsidiary can be attributed. Egelie argues that this could lead to the recognition of the same business loss in two EU MSs (once as a regular business loss in one EU MS and once as a liquidation loss in another EU MS).

On the basis of primary EU law as it currently stands, EU MSs are entitled to counter double-dip risks. The right of EU MSs to guarantee that losses are not taken into account twice has been confirmed, amongst others, in the Lidl case. In the Lidl case, the Court of Justice allowed Germany to apply the base exemption as a double tax relief method. The application of a

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<sup>25</sup> See Egelie, *supra* note 2. Apart from Egelie, Dutch tax scholars are virtually unanimous in the opinion that the Dutch tax consolidation regime is incompatible with EU law in this respect. See Engelen 2009, *supra* note 2 at section 3, Kok, *supra* note 2 at section 7, Kiekebeld, *supra* note 2 at section 4, Bosch, *supra* note 2 at section 5 and Van Raad, *supra* note 2 at section 5.

<sup>26</sup> See Court of Justice case C-418/07 (Papillon). See also Court of Justice case C-200/98 (X AB & Y AB).

<sup>27</sup> The Court of Justice also referred France to the possibility to obtain information from other EU MSs' tax administrations on the basis of the EU Mutual Assistance Directive.

base exemption ensures that foreign income items (both profits and losses) are kept outside the domestic tax base (the territoriality principle). Both double taxation and double loss compensation are thereby prevented. Accordingly, the base exemption is a suitable and effective measure to keep foreign income outside the domestic tax base. Subsequent to recognizing this effect, the Court of Justice ruled that Germany acknowledges the proportionality test.

The same conclusion can be drawn from the Marks & Spencer II case. EU MSs are allowed to keep foreign income outside the domestic tax base. In scenarios where the foreign business income is exempt from tax, an EU MS legitimately expresses the territoriality principle.<sup>28</sup> From the facts of the case it can be deduced that the United Kingdom (UK) adopts the separate entity approach as well (just as is the case in the Netherlands): each corporate entity is taxed on an individual basis. Consequently, the aggregation of losses and profits realized by the various affiliates of the same group within the tax year (horizontal loss compensation) is denied. This distorting effect of the separate entity approach is subsequently rectified in the UK by allowing horizontal loss compensation under the so-called group relief regime. Prior to the Marks & Spencer II ruling, the application of the group relief regime was subject to the requirement that the group companies involved were UK tax residents. The application of the group relief regime was denied to foreign resident group companies. As a result of the regime's limited scope of application, the losses realized out of the non-UK resident group companies' foreign business activities are kept outside the UK tax base. The separate entity approach applies unimpaired. Current foreign business losses are 'exempt' from UK tax. The Court of Justice ruled that the territoriality principle generally legitimizes the UK to limit the group relief regime's scope of application to domestic group companies. The import of foreign losses to the UK (the state of origin) is not required. At any rate, as long as locally, i.e. in the EU MS where the respective foreign group company is situated (the host state), vertical loss compensation (the set-off of losses realized in another tax year) is allowed. However, to the extent that the vertical loss set-off possibilities (in effect) have been exhausted (e.g. due to the expiry of loss carry-forward terms or upon the liquidation of the local group company), the import of foreign losses into the UK is required (the 'M&S final losses exception').

Egelie demonstrates that the Dutch tax consolidation regime effectively prevents double dipping by only allowing tax consolidation of foreign group companies under the PE variant.<sup>29</sup> Foreign source business income is kept outside the Dutch corporate tax base in an effective manner. Foreign business income is exempt from Dutch tax. Double loss compensation is thereby prevented. Consequently, the Dutch tax consolidation regime, contrary to its French equivalent, would be a "sufficiently proportional". The different corporate tax treatment of Dutch resident group companies in comparison with non-Dutch resident group companies would be justified accordingly.

The question whether EU law as it currently stands obliges the Netherlands to allow the tax consolidation of Dutch resident 'sister companies' (section 3, scenario 2), without simultaneously consolidating their joint (non-Dutch but nevertheless) EU-resident parent company can be answered negatively on the basis of a similar reasoning. Here, too, it can be argued that the different corporate tax treatment under the tax consolidation regime can be justified by overriding reasons in the general interest. From the Court of Justice's case law it can be concluded that the tax consolidation regime discriminates against foreign shareholding companies in the event that the Dutch sister companies cannot be consolidated on the ground that their joint parent has its place of tax residence outside the Netherlands (i.e. in another EU MS). For example, in the *Metallgesellschaft* and *Hoechst* cases, the Court of Justice ruled that the UK discriminated against foreign (in these cases German-based) shareholding companies where it did not allow a postponement of Advanced Corporation Tax with respect to intra-group dividend distributions (up until the dividend is distributed to a minority shareholder) on the ground that the parent company receiving the dividend payment resides in an EU MS other than the UK.<sup>30</sup> In the *Metallgesellschaft* and *Hoechst* cases, the Court of Justice did not recognize a

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<sup>28</sup> Subject to the provision that the M&S final losses exception has been met.

<sup>29</sup> For a detailed explanation, reference can be made to Egelie, *supra* note 2.

<sup>30</sup> See *Metallgesellschaft* and *Hoechst*, *supra* note 20.

justification for this unequal tax treatment as there was no risk that the UK would be unable to tax the corporate business income of the group realized within UK territory.<sup>31</sup>

Under the PE variant, Dutch sister companies can be consolidated under the tax consolidation regime together with their mutual parent company. In the event that the freedom of establishment would require the tax consolidation of these companies without simultaneously consolidating their mutual EU resident parent company, the double-dip risk would also become apparent (a regular business loss in one EU MS and then again as a liquidation loss in another EU MS). The PE variant prevents this double-dip risk. Foreign business income is thereby being kept outside the Dutch corporate tax base. With that, the Dutch tax consolidation regime would be sufficiently proportional. The differences in corporate tax treatment would be justified accordingly.

The question whether EU law forces the Netherlands to adopt a cross-border tax consolidation regime (section, 3, scenario 3) was asked by the Dutch Supreme Court as a preliminary question to the Court of Justice on July 11, 2008: the X Holding case.<sup>32</sup> This question can also be answered in the negative on the basis of the Lidl and Marks & Spencer II cases.<sup>33</sup> By denying tax consolidation and, with that, maintaining the separate entity approach in scenario 3, the Netherlands in effect keeps the business income that groups realize abroad outside the domestic tax base on the basis of a base exemption. And the Court of Justice ruled the base exemption compatible with EU law in the Lidl and Marks & Spencer II cases. In addition to this, it may be argued that the Netherlands even appreciates the M&S final losses exception as the liquidation of a non-consolidated (foreign) subsidiary triggers the application of the supplementary Dutch liquidation losses set-off regime. Also in this scenario, the territoriality principle is effectively expressed. Consequently, on the basis of the Court of Justice's case law as it currently stands, the Dutch tax consolidation regime can be considered to be sufficiently proportional and, hence, accordingly compatible with the freedom of establishment.

It is this line of reasoning on the basis of which AG Kokott reached the conclusion that the Dutch tax consolidation regime is in line with the freedom of establishment. Well, she argued that this holds true at least to the extent that it concerns the effect that the consolidation regime's limited scope of application entails that aggregation of current business profits and losses realized by resident and non-resident group companies is impossible. In this respect, it should be noted that she left the M&S final losses exception out of consideration.<sup>34</sup> To the extent that it concerns the different tax treatment of consolidated group companies in comparison with non-consolidated (foreign) group companies with respect to intra-group transactions and intra-group business restructurings, AG Kokott advocated a slightly different approach. In that respect, she opined that the territoriality principle may justify the different tax treatment as well. However, she arrived at the conclusion that it is up to the domestic tax court to decide on the question whether the tax measure is sufficiently proportional.

In its ruling in the X Holding case, the Court of Justice adopts the aforementioned line of reasoning as well. The tax consolidation regime secures that foreign source business income is effectively being kept outside the Dutch corporate tax base. Therefore, the Dutch measure can be considered as a justified obstacle. Worth to note is that the Court of Justice, just like AG Kokott, does not address the M&S final losses exception whatsoever. With that, the court conceptually seems to move away from its earlier approaches in its Bosal and Marks & Spencer II rulings back towards its original stand on the territoriality principle in the Futura case: "distortions resulting from application of the territoriality principle are disparities".<sup>35</sup> But what does that entail? Did the Court of Justice get rid of the M&S final losses exception in the X Holding case? In addition to this, contrary to AG Kokott, the Court of Justice does not differentiate between the non-aggregation of business income realized by the resident and non-resident group companies on

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<sup>31</sup> For a detailed description of the mechanism applied in the (former) UK international tax system, reference can be made to Metallgesellschaft and Hoechst, *supra* note 20, as well as Court of Justice cases C-374/04 (Class IV) and FII, *supra* note 7.

<sup>32</sup> See HR July 11, 2008, case C-337/08, V-N 2008/34.14, BNB 2008/305 (X Holding). See also Opinion of AG Wattel of July 4, 2007, V-N 2007/47.16 (AG Wattel 2007) and Opinion of AG Wattel of September 11, 2008, V-N 2008/47.14 (AG Wattel 2008).

<sup>33</sup> Cf. AG Wattel 2008, *supra* note 32.

<sup>34</sup> See also Weber, *supra* note 2.

<sup>35</sup> See respectively Court of Justice, cases C-168/01 (Bosal), Marks & Spencer II, *supra* note 7 and C-250/95 (Futura).

the one hand and the recognition for tax purposes of intra-group transactions (e.g. internal reorganizations, asset transfers and intra-group services and supplies of goods) on the other hand. What does this mean? Does this imply that the exit taxes the Netherlands imposes on cross-border intra-group asset transfers are compatible with the freedom of establishment? Did the Court of Justice get rid of its approaches in the *N. and Lasteyrie* cases?<sup>36</sup> Weber wrote in a comment on the opinion of AG Kokott in the *X Holding* case that he “cannot imagine that the ECJ will follow the AG on this point. If it does, we will all be back to where we started.”<sup>37</sup> I guess we are.

#### **4.2 “Door B”: in concreto incompatible: “effective but inefficient and therefore disproportional”**

Again, as said, there is also case law available on the basis of which the Court of Justice could have deduced an exact opposite conclusion. In particular, reference can be made to the joint cases *Metallgesellschaft and Hoechst* and the *Renneberg* case.<sup>38</sup> This case law provides room for “Door B”: the Dutch tax consolidation regime is incompatible with the freedom of establishment in concreto. I favour this approach. Therefore, in the underlying section, I do not only merely seek to illustrate the respective reasoning but also to explain why I prefer this approach over the one laid down in section 4.1 in the above.

The key element in the reasoning is the assumption that EU MSs are allowed to keep foreign income out of their domestic tax base, subject to the requirement that they do this in an *economically efficient* manner. Double loss compensation may be countered. However, the expression of the territoriality principle in the respective EU MSs’ international tax system needs to function in a tax-neutral manner. The tax measure should not only be effective, but also economically efficient. The current Dutch tax consolidation regime functions effectively, but is nevertheless economically inefficient. It distorts the functioning of the internal market without internal frontiers. The tax regime is therefore disproportional and accordingly incompatible with the freedom of establishment.<sup>39</sup>

It is true that, in accordance with the *Lidl* and *Marks & Spencer II* rulings, EU MSs appear to be not required to seek a tax-neutral, or economically efficient, method in attempting to keep foreign income items outside their domestic tax bases. The base exemption, as approved in *Lidl*, and *Marks & Spencer II* (and now in *X Holding* as well), which (materially) applies in the Netherlands, is an effective but inefficient method for the purpose of countering double loss compensation. Unilaterally imposed distortions of the internal market are maintained under this method. The application of a base exemption in an intra-EU context has the effect of making horizontal loss compensation with respect to intra-EU establishments impossible. This is true whereas business profits and losses realized within a tax year in a non-intra-EU (domestic) context may be aggregated. Consequently, taxpayers conducting their business activities in an intra-EU context need to resort to local vertical loss set-off arrangements.<sup>40</sup> Current local losses may only be set-off against future profits (with respect to which it is uncertain whether these profits will ever be realized). Under the application of the UK group relief mechanism this is true with respect to losses realized by foreign group companies. Under the German base exemption this is true for foreign PE losses. This results in liquidity (cash flow) disadvantages with regard to non-definitive losses realized out of intra-EU business activities. In addition to this, the application of a base exemption in an intra-EU context has the consequence that internal dealings and intra-group transactions (i.e. transactions between non-consolidated group companies) are recognized as a taxable event for which an at arm’s length price needs to be taken into consideration. Such

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<sup>36</sup> See Court of Justice, cases C-9/02 (*De Lasteyrie du Saillant*) and C-470/04 (N.).

<sup>37</sup> See Weber, *supra* note 2.

<sup>38</sup> See *Metallgesellschaft and Hoechst*, *supra* note 20 and Court of Justice case C-527/06 (*Renneberg*).

<sup>39</sup> Contra AG Kokott, *supra* note 2. She pointed out that the Court of Justice in *Lidl*, *supra* note 7 did not consider it necessary for EU MSs to prevent liquidity disadvantages. Unfortunately, AG Kokott did not provide an answer to the question of why the Court of Justice considered unilaterally imposed liquidity disadvantages incompatible with EU law in *Metallgesellschaft and Hoechst*, *supra* note 20 and *FII*, *supra* note 7. She also left untouched the question how this case law relates to the Court of Justice’s judgment in *Lidl*, *supra* note 7, and *Marks & Spencer II*, *supra* note 7.

<sup>40</sup> See AG Wattel 2007, *supra* note 32 and HR July 11, 2008, case C-337/08, V-N 2008/34.14, BNB 2008/305 (*X Holding*).

dealings and transactions trigger current corporate tax liability, whereas this is not the case with comparable internal dealings and intra-group transactions (i.e. transactions between consolidated group companies) in a non-intra-EU (purely domestic) context. The intermediate corporate tax liability due to the differences in corporate tax treatment result in cash flow disadvantages. However, apparently the Court of Justice does not really seem to have any problems with these unilaterally imposed disadvantages. It is a fact that the Court of Justice did not require Germany in the Lidl case to seek an economically efficient expression of the territoriality principle in its international tax system (such as a tax exemption instead of a base exemption). And the Court of Justice did not force the UK in the Marks & Spencer II case to horizontally compensate foreign losses with UK source profits, despite the fact that the UK horizontally aggregates business profits and losses realized domestically. Moreover, as of the rendering of the X Holding ruling, the Netherlands is neither required to horizontally aggregate foreign losses with Dutch source profits, nor seems to be required to do something about the exit taxes with respect to cross-border intra-group asset transfers.

It appears that the Court of Justice implicitly allows EU MSs – at least Germany, the UK and now the Netherlands as well – some margin under the proportionality test. AG Kokott showed evidence of this approach as well. Viz., without the recognition of an implicit margin, the Court of Justice could never have ruled that the German and UK base exemptions are compatible with EU law. Moreover, AG Kokott could not have been of the opinion that the Dutch tax consolidation regime is compatible with the freedom of establishment. And the Court of Justice could not have followed the reasoning of AG Kokott in the X Holding case. Namely, the base exemption functions inefficiently. Apparently, EU MSs are ‘more or less’ entitled to maintain unilaterally imposed obstacles: somewhat proportional suffices.

However, is it right that EU MSs have a margin of appreciation? I would say no. Unilaterally imposed distortions of the internal market do not principally coincide with the two cornerstone principles on the basis of which the internal market without internal frontiers is founded upon: market neutrality and market equality. The approval of a margin entails the approval of unilaterally imposed obstacles. And that simply cannot be considered just in the envisaged common market without internal frontiers. With the acceptance of a margin of appreciation in the Marks & Spencer II and Lidl cases, the Court of Justice embarked on a slippery slope. And today, that slippery slope has been established once more in the X Holding case. In my view, this is not only unjust; it also leads to unnecessary questions which are very difficult, maybe even impossible, to answer. How far does this margin extend? What does sufficiently proportional mean? How should the proportionality test be interpreted regarding – for example – the different tax treatment that results from the non-application of the Dutch tax consolidation regime in intra-EU scenarios with respect to intra-group (financing) transactions and reorganisations? Should every individual element that the application of the tax consolidation in an intra-EU context would otherwise entail be individually analysed as to its proportionality (‘per element approach’)?<sup>41</sup> This leaves room for numerous preliminary questions (and unnecessary legal uncertainty).

As I see it, each expression of the territoriality principle in the international tax system of an EU MS is necessarily disproportional as long as the same effect can be guaranteed with an economically efficient alternative. With regard to the distorting Dutch base exemption, the alternative is already available in the Dutch international tax system: the tax exemption. This double tax relief method attains the same effects as the base exemption, but nevertheless in an economically efficient manner. The combination of cross-border tax consolidation and tax exemption guarantees that the foreign business income realized by the non-Dutch resident group companies is effectively kept outside the Dutch tax base. Double loss compensation is prevented by the ‘carry forward of foreign profits’ (doorschuifregeling) and the ‘recapture of foreign losses’ (inhaalregeling) mechanisms. Moreover, as mentioned in section 3 in the above, latent corporate tax claims on hidden reserves do not become due when capital assets are transferred from Dutch territory to abroad.<sup>42</sup> Single taxation can be guaranteed by applying the tax exemption subject to the requirement that the foreign income is subject to a corporate tax (perhaps accompanied by a

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<sup>41</sup> See also Weber, *supra* note 2.

<sup>42</sup> See Hopperzuiger, *supra* note 17.

switch-over to the ordinary credit method in the event that the taxpayer fails to meet the subject to tax clause).<sup>43</sup> Tax abuse may accordingly be tackled. The combination of cross-border tax consolidation and tax exemption is as effective as the PE variant. However, (liquidity) disadvantages do not occur. The same effect is achieved in a tax neutral, economically efficient, and therefore proportional manner. This would make the PE variant superfluous for foreign group companies. The fact that an economically efficient alternative to the current consolidation regime is available proves that the current regime is in abstracto disproportional. Unfortunately, the Court of Justice failed to recognize this. Contrary to what the Court of Justice observes, cross-border tax consolidation simply would not undermine a balanced allocation of taxing powers: cross-border tax consolidation would lead to the application of the tax exemption methodology by analogy. There even is case law of the Dutch Supreme Court available in which this effect is explicitly recognized.<sup>44</sup> X Holding BV and the European Commission submitted this effect under the Dutch international tax system to the court explicitly. Unfortunately, the Court of Justice failed to appreciate this.

In concreto, the Dutch tax consolidation regime could have been considered incompatible with the freedom of establishment on the basis of the ruling of the Court of Justice in the joint cases *Metallgesellschaft and Hoechst*. On the basis of this Court of Justice ruling, unilaterally imposed liquidity disadvantages are obstacles as well.<sup>45</sup> As said, due to the Dutch tax consolidation regime's limited scope of application, the Netherlands materially applies a base exemption with respect to the foreign business income of non-Dutch resident group companies (scenarios 1 through 3, mentioned in section 2). Accordingly, the Netherlands unilaterally imposes liquidity disadvantages. These disadvantages are not imposed in the comparable scenarios b) and d) where the foreign business income is realized by Dutch-resident group companies. In that event, the foreign business income is kept outside the Dutch tax base on the basis of the tax exemption mechanism. This difference in tax treatment cannot be reconciled with the judgment of the Court of Justice in the *Metallgesellschaft and Hoechst* cases.

The incompatibility of the Dutch tax consolidation regime with the freedom of establishment could also have been based on the ruling of the Court of Justice in the *Renneberg* case. This case makes it evident that the Netherlands does not have a margin of appreciation in securing that foreign income items are kept outside the Dutch tax base. This deserves some further elaboration. The Court of Justice ruled that the Netherlands, without justification, discriminated against non-resident taxpayers (individuals) in comparison with resident taxpayers (individuals) where the Netherlands excluded non-residents' foreign income items from the Dutch tax base by (materially) applying a base exemption, while a tax exemption was applied with respect to the foreign income items of Dutch resident taxpayers.<sup>46</sup> Due to the different double tax relief methods for resident (tax exemption) and non-resident (base exemption) taxpayers, non-resident taxpayers were unable to set-off negative foreign income items (in this case interest expenses relating to the financing of personal dwellings) against positive domestic (Dutch) income items. Resident taxpayers could do this. This difference in tax treatment between resident taxpayers and non-resident taxpayers entailed that the latter were confronted with a higher effective tax burden in the Netherlands. And this effect was merely caused by the fact that non-resident taxpayers had their place of tax residence outside the Netherlands. The Court of Justice,

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<sup>43</sup> See for comparison, *Cadbury*, *supra* note 7 and *Part Service*, *supra* note 7.

<sup>44</sup> See HR March 16 1994, BNB 1994/191, HR June 29, 1988, BNB 1988/331 and HR November 13, 1996, BNB 1998/47.

<sup>45</sup> See *Metallgesellschaft and Hoechst*, *supra* note 20 and in this respect *FII*, *supra* note 7. See also AG Sharpston in *Lidl*, *supra* note 7. See for comparison *Van Dijk*, *supra* note 2 at sections 6-7 and *Bosch*, *supra* note 2 at section 6. Contra *Marks & Spencer II*, *supra* note 7, *Lidl*, *supra* note 7 and *AG Kokott*, *supra* note 2.

<sup>46</sup> See for comparison, *Irish dual resident*, *supra* note 18 and *Frontier worker*, *supra* note 18. The fact that the tax measure at hand in *Renneberg*, *supra* note 38, was a Dutch tax subsidy for the purpose of stimulating the private ownership of dwellings is, in my view, irrelevant. Where it concerns the interpretation of the fundamental freedoms, the Court of Justice is not a tax court. In this respect, the Court of Justice may be referred to as a 'constitutional' court that judicially reviews the domestic legal orders of the EU MSs, including their international tax systems, concerning principles of supranational EU law, as found in the TEU and the TFEU. The relevance of *Renneberg*, *supra* note 38, lies in the Court of Justice's interpretation of the equality principle in EU law and with that its ruling on the differences in the tax treatment of taxpayers on the basis of their place of tax residence.

in my view correctly, failed to see why this unequal income tax treatment of taxpayers in equal circumstances could be justified.

With respect to the corporate tax treatment of foreign business income realized by individual corporate entities and groups, the territoriality principle is expressed in the Dutch CITA in a discriminatory manner. Moreover, the corporate tax treatment in the Netherlands unilaterally distorts the economic operator's decisions on the choice of legal form.<sup>47</sup> The foreign business income of both resident and non-resident taxpayers (individual corporate entities as well as groups) is effectively kept outside the Dutch corporate tax base. However, depending on the manner in which the business affairs have been arranged legally (the legal form chosen) and the place of the tax residence of the group companies involved, the Netherlands arbitrarily decides between the distorting base exemption and the economic efficient tax exemption. The application of the base exemption is reserved for the foreign business income of non-resident corporate taxpayers and group companies. The application of the tax exemption is reserved for the foreign business income of Dutch resident corporate taxpayers and (consolidated) group companies. Economically equal scenarios are treated unequally for corporate tax purposes. This reality cannot be reconciled with the judgment of the Court of Justice in the *Renneberg* case.

Notably, it should be observed that the Dutch Supreme Court's AG Wattel dealt with the details of the Court of Justice's comparability analysis in the *Renneberg* case. In his (further) opinion, delivered subsequent to the ruling of the Court of Justice in the *Renneberg* case, the AG opined that the Court of Justice had unjustly ruled that resident and non-resident taxpayers find themselves in equal circumstances.<sup>48</sup> For that purpose, he put forward that the Netherlands does not have the power to tax the foreign (i.e. non-Dutch source) income of Belgian resident taxpayers on the basis of the double tax convention concluded between the Netherlands and Belgium.<sup>49</sup> The taxing powers with respect to these income items are not allocated to the Netherlands. AG Wattel argued that the Court of Justice incorrectly failed to appreciate the manner in which the Netherlands and Belgium distributed their taxing rights amongst each other. Consequently, according to Wattel, the difference in corporate tax treatment was not the result of discrimination imposed by the Netherlands, but resulted from the fact that the respective non-resident taxpayers had earned their income in various EU MSs ('dislocations').

It is my impression that the Court of Justice took the correct turn in *Renneberg*, though.<sup>50</sup> It is true that sovereignty in the field of direct taxation currently lies at the level of the Member States. A basic principle of EU law is that the founding of the EU did not entail a transfer of competence to levy direct taxes from the Member States to the EU. This means that EU MSs are competent to decide on whether or not to tax. EU MSs are sovereign in their decision as to who to tax (taxable unit), what to tax (tax base) and at which rate (tax rate). In addition to this, EU MSs are competent to distribute their competence to tax amongst each other through double tax conventions.<sup>51</sup> However, established case law of the Court of Justice adequately reveals that the EU MSs nevertheless have to exercise their competence in direct taxation consistently with the free movements.<sup>52</sup> This means that the manner in which the sovereign decisions of the EU MSs are subsequently expressed in their respective international tax systems falls within the material

<sup>47</sup> Contra AG Kokott, *supra* note 2 and HR 2 oktober 2009, V-N 2009/49.22.

<sup>48</sup> See Opinion of AG Wattel, February 10, 2009, LJN: BH4064, V-N 2009/21.8.

<sup>49</sup> See for comparison: Irish dual resident, *supra* note 18 and Frontier worker, *supra* note 18.

<sup>50</sup> Unfortunately, the Court of Justice chose to adopt its approach in case C-279/93 (*Schumacker*; personal allowances) instead of its approach in *Marks & Spencer II*, *supra* note 7 (territoriality and anti-tax abuse). The Court of Justice considered resident and non-resident taxpayers to be in comparable circumstances, as EU MSs exercise their taxing powers on both of them. However, when the tax treatment of personal allowances is the subject of debate, the Court of Justice, in my view for indistinct reasons, adopts an alternate reasoning. In that event, non-resident taxpayers are only in a comparable position with resident taxpayers when these non-resident taxpayers earn 90% or more of their income in the source state (90%-threshold). See for comparison, B.J.M Terra and P.J. Wattel, *supra* note 5 at p. 51.

<sup>51</sup> Cf. Vanistendael, *supra* note 5, at p. 90-98, Frans Vanistendael, *Memorandum on the taxing powers of the European Union*, 3 EC Tax Review 120 (2002) at section 3 and Frans Vanistendael, *Common (Tax) Law of the ECJ*, 6 EC Tax Review 250 (2007). p. 250-251.

<sup>52</sup> See ECJ, cases C-336/96 (*Gilly*), *Marks & Spencer II*, *supra* note 7, C-265/04 (*Bouanich*), *Saint Gobain*, *supra* note 9 and *Denkavit Internationaal*, *supra* note 8. The same applies under the case law of the EFTA Court with respect to the Member States of the European Economic Area (Iceland, Liechtenstein and Norway, plus the EU MSs). See EFTA Court, E-7/07 (*Seabrokers*).

scope of application of supranational EU law. Notably, the international tax system of an EU MS comprises both its domestic tax legislation and its double tax convention network. Consequently, not only the manner in which EU MSs have created their taxing rights in their domestic tax legislation falls within the material scope of application of supranational EU law, this is also true with respect to the manner in which they have distributed their taxing powers amongst each other through double tax conventions.<sup>53</sup>

The only reason why the Netherlands, acting as the host state in the Renneberg case, has no power to tax the foreign income of its non-resident taxpayers, is because that is what the Netherlands has agreed upon with Belgium in their bilateral double tax convention. With respect to resident taxpayers, the Netherlands arranged the power to include foreign source income items (both positive and negative) in the domestic tax base (the ‘tax base reservation’). The Netherlands did not arrange the tax base reservation for its non-resident taxpayers. Their foreign income items are consequently excluded from the Dutch tax base. This is only because they have their tax place of residence in Belgium. The Netherlands could just as well not have made this distinction and could have extended the tax base reservation to all taxpayers, irrespective of their place of residence. Then, the Netherlands would have been entitled to include the non-resident taxpayers’ foreign income in the domestic tax base. As long as the Netherlands appreciates Belgian taxing powers, by granting double tax relief with respect to Belgian residents’ foreign (i.e. non-Dutch) income, Belgium would not be worse off at all. Notably, the Netherlands already does this (upon request) for individuals. Non-resident taxpayers, individuals, may opt for unlimited tax liability. The taxing powers of the Netherlands’ treaty partners are considered as the Netherlands provides for double tax relief with respect to the taxpayer’s foreign (non-Dutch) income.<sup>54</sup> If I understand Wattel’s reasoning correctly - in the event that the application of the tax base reservation would be extended to all taxpayers - resident and non-resident taxpayers would end up finding themselves in equal circumstances. This means that, in Wattel’s reasoning, resident and non-resident taxpayers are not objectively comparable because the Netherlands and its treaty partner have agreed upon to subject them to different tax treatment. Hence, the difference in tax treatment becomes an argument to advocate the inequality of the circumstances. I do not believe that this is just. In my view, resident and non-resident taxpayers find themselves in equal circumstances, plainly because the Netherlands exercises its sovereign taxing powers over both of them.<sup>55</sup> They are nevertheless treated differently, solely on the basis of their place of residence. According to the Court of Justice in its Renneberg ruling, and in my view on just grounds, this different tax treatment is discriminatory. As a result of this, the Netherlands should apply (*in justice*) the same methodology to both resident and non-resident shareholders (unlimited tax liability with a tax exemption for foreign income).<sup>56</sup>

In her Opinion in the X Holding case, AG Kokott advocated a similar reasoning as AG Wattel. In order to justify the different tax treatment of resident and non-resident group companies under the Dutch tax consolidation regime (as seen from the perspective of the Netherlands as the state of origin), she argued that PEs and foreign subsidiaries do not find themselves in comparable circumstances with respect to the manner in which the EU MSs have distributed the taxing powers amongst each other. The Court of Justice explicitly follows this element of AG Kokott’s reasoning in the X Holding case (observation 38). In itself, the observation that double tax conventions distribute taxing powers regarding the business profits of multinational enterprises differently depending on the question of whether the foreign business income has been realized by a subsidiary or a PE is correct. Foreign business profits realized by a foreign subsidiary are completely kept outside the corporate tax base in the Netherlands (acting as the

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<sup>53</sup> See Bouanich, *supra* note 52. See also Opinion of AG Bot of July 9, 2009 in Court of Justice case C-182/08 (Glaxo Wellcome).

<sup>54</sup> The tax regime can be found in Article 2.5 of the Dutch Individual Income Tax Act 2001. Note that my interest in this respect is mainly devoted to the mechanism conceptually rather than the distorting manner in which it has been laid down in the current Dutch tax legislation.

<sup>55</sup> See Denkavit Internationaal, *supra* note 8.

<sup>56</sup> Or, in other words, the application of the ‘art. 2.5 IB 2001-mechanism’ *in jure*. The application of such a mechanism conflicts with the internationally commonly applied mechanisms of international taxation where the place of residence plays such a prominent role. See for comparison E.C.C.M. Kemmeren, *Renneberg Endangers the Double Tax Convention System or Can a Second Round Bring Recovery?*, 1 EC Tax Review 4 (2009) at p. 4-15.

state of origin). Neither the foreign subsidiary nor its business profits realized are subject to corporate tax. The 'tax base' (i.e. the foreign business income) is in effect 'exempt' from Dutch tax. In the event that the foreign business profits have nevertheless been realized by a PE situated abroad, these business profits are kept outside the Dutch corporate tax base as well. However, contrary to the foreign subsidiary, foreign business income is kept outside the Dutch tax base through the application of the tax exemption mechanism. The income is first included in the corporate tax base and is subsequently exempted from tax. In my view, this difference in corporate tax treatment nonetheless does not entail that from this the conclusion may be drawn that PEs and subsidiaries find themselves in different circumstances. The different tax treatment of foreign subsidiaries in comparison with PEs is *just* the problem that is under discussion in the X Holding case. Just as in the reasoning of AG Wattel, AG Kokott – and the Court of Justice in its X Holding ruling – employs the differences in corporate tax treatment (i.e. the divergent way in which the taxing powers are distributed with respect to foreign PEs in comparison with foreign group companies) as an argument to find the inequality of the circumstances. In my view, that is turning the world upside down. If it had been chosen to allocate the taxing powers in exactly the same manner, for example, by recognizing (sub-)subsidiaries as PEs of the (ultimate) parent company (or, even better, as fiscally transparent),<sup>57</sup> Kokott's and the Court of Justices's reasoning – if I am not mistaken – would entail that PEs and foreign subsidiaries would be considered to be in similar circumstances. I think that this thought experiment proves that Kokott's reasoning cannot be sound. The same is true for the court's reasoning in the X Holding case. Unequal tax treatment simply cannot be justified by pointing to the differences in tax treatment.

## 5 Inferences

So where do we stand today? In my view, the aforementioned boils down to the notion that it is unclear whether the Court of Justice allows EU MSs some leeway under the proportionality test when they express the territoriality principle in their international tax systems. An affirmative answer to this question can be derived from the Marks & Spencer II, Lidl and X Holding cases. Basically following the footprints it left behind in Marks & Spencer II and Lidl, the Court of Justice found sufficient grounds for the conclusion that the Dutch tax consolidation regime – despite the remaining (liquidity) disadvantages – is compatible with EU law ("Door A"). The differences in corporate tax treatment that the Netherlands imposes apparently fall within the margin of appreciation. However, the Metallgesellschaft and Hoechst cases, as well as the Renneberg case, do not demonstrate a permissible margin. This case law could have provided sufficient grounds for the exact opposite conclusion: the regime is incompatible with EU law ("Door B"). The Netherlands infringes the freedom of establishment as it unilaterally imposes obstacles by maintaining the (liquidity) disadvantages that occur as a consequence of the different tax treatment of non-resident (base exemption) and resident (tax exemption) corporate taxpayers and groups. As said, AG Kokott did not fully appreciate this in her Opinion in the X Holding case. And so did the Court of Justice.

The Court of Justice's case law provides sufficient grounds for diverging, perhaps even random, conclusions. What does this say? In my view, this says that the Court of Justice does not provide a sufficient guideline for identifying an unambiguous normative framework for the purpose of answering the question of when EU MSs impose an obstacle. To which rulings do we have to refer to? To Lidl and Marks & Spencer II? To X Holding? Or to Metallgesellschaft and Hoechst and Renneberg? And why? For the purpose of finding such a normative framework, I believe that it has been made necessary to move past the Court of Justice and fall back on the underlying objective of pursuing a common market without internal frontiers. I sought to illustrate the concept of the internal market in section 2. When taking that standard, it becomes evident that the Dutch

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<sup>57</sup> See for comparison Brian J. Arnold, *Threshold requirements for Taxing Business Profits under Tax Treaties*, 2003 Bulletin for International Taxation 476 at p. 492. On the basis of Article 5, paragraph 7, OECD Model Convention, subsidiaries are not regarded as a PE of their parent company. It should be noted that the Dutch Supreme Court nevertheless does not seem to have problems with allowing the cross-border tax consolidation under domestic tax legislation to have effect under the Dutch double tax convention network. See HR March 16, 1994, BNB 1994/191, HR June 29, 1988, BNB 1988/331 and HR November 13, 1996, BNB 1998/47. Contra Irish dual resident, *supra* note 17.

tax consolidation regime is incompatible with the freedom of establishment in abstracto as a result of its economically inefficient functioning in an intra-EU context. In my view, EU MSs are required to seek an economically efficient expression of the territoriality principle in their international tax systems. Regrettably, the Court of Justice did not confirm this in X Holding and left things indistinct as to its interpretation of the proportionality test.

## **6 Concluding remarks**

On February 25, 2010, the Court of Justice ruled that the Dutch tax consolidation regime is compatible with the freedom of establishment. The Netherlands seem to be enabled to retain the tax consolidation regime in its current design. Unfortunately, the Dutch tax consolidation regime should have been considered incompatible with the freedom of establishment. The concept of the internal market without frontiers requires that an economic operator's change of tax jurisdiction within the internal market may not be unilaterally distorted by EU MSs. This entails that the proportionality test cannot be explained other than that EU MSs are indeed entitled to keep foreign income items out of their domestic tax base. But when they do express the territoriality principle in their international tax systems, they need to arrange this in an economically efficient manner. In the Netherlands, this calls for a combination of cross-border tax consolidation and a tax exemption. Only under that condition does the Netherlands unilaterally not distort the functioning of the internal market without internal frontiers. Nevertheless, the Court of Justice did not confirm the incompatibility of the Dutch tax consolidation regime in the X Holding case. Consequently, the Court of Justice's interpretation of the proportionality test remains flawed. It has become completely indistinct whether EU MSs are granted some leeway (and, if yes, to what extent?) in the manner in which they express the territoriality principle in their international tax systems. Consequently, an unambiguous normative framework for the purpose of identifying obstacles in the EU cannot be derived from the Court of Justice's case law. For this, it is necessary to fall back on the underlying objective of pursuing a common market without internal frontiers. In scenarios falling within the scope of application of the TFEU, in my view, an EU MS imposes an obstacle in the event that the domestic tax burden on income realized out of cross-border (i.e. intra-EU) business activities differs from the domestic tax burden on the income realized out of non-cross-border (i.e. purely domestic) business activities.