European Union

CFE ECJ Task Force*

Opinion Statement ECJ-TF 3/2019 on the ECJ Decision of 22 November 2018 in *Sofina* (Case C-575/17) on Withholding Taxes, Losses and Territoriality

This CFE Opinion Statement, submitted to the EU Institutions on 10 October 2019, comments on the decision in *Sofina* (Case C-575/17), in respect of which the Fifth Chamber of the ECJ delivered its decision on 22 November 2018. The Court held that the imposition of French dividend withholding tax violated the freedom of capital movement in light of the non-resident's overall loss situation.

1. Executive Summary

The CFE Tax Advisers Europe note that the Court's decision in *Sofina* may have extended the standard of comparability, requiring (foreign) non-dividend income of the recipient to be taken into consideration in comparing the tax treatment of domestic and outbound dividends. This comparator, however, upsets the principle of territoriality, as accepted by the Court in *Futura* (Case C-250/95) and *Centro Equestre* (Case C-345/04), by requiring the source state to take into account losses that the non-resident taxpayer has in the residence state.

Taken at face value, *Sofina*'s[1] impact may extend well beyond withholding taxes, specifically, and dividend taxation, more generally, by attaching a "no-loss" condition to all source state taxing rights. It may arguably even bar the permanent establishment (PE) state from taxing profits attributable to that PE if the foreign head office is in a loss position.

Moreover, applying *Sofina* to everyday international tax law might also not be an easy task and push administrative feasibility to its limits. The Court effectively seems to propose a non-discriminatory deferral of taxation, combined with a domestic regime, that leads to a subsequent recapture if (and only if) the non-resident taxpayer becomes profitable during a subsequent tax year.

2. Background and Issues

Sofina intertwines two issues that have, so far, been approached separately in ECJ case law: (dividend) withholding taxes, on the one hand, and the relevance of overall profitability of an entity in the source state, on the other. The Court's decision thus has potential implications far beyond the narrowly circumscribed issue of the case.

The complainants in the case were three Belgian companies who applied, in France, for a reimbursement of dividend withholding tax levied for years during which these companies were in an overall loss position. They argued that the withholding tax put them at a disadvantage compared to French resident companies, which were not subject to withholding tax in the same circumstances.

Under French corporate tax rules, dividends received by a resident company are included in the normal tax base. They are thus subject to the ordinary 33.33% tax rate if the company is in an overall profit position but the dividends reduce a loss carry-forward if the company has overall negative income in the year it received such dividends. As a result, ignoring the different tax bases[2] (and rates),[3] resident taxpayers would benefit from a cash-flow advantage (if they returned to profitability) or even a permanently lower tax burden (if they never became profitable).

Relying on the ECJ's decision in *Truck Center*,[4] French case law[5] had previously held this system to be compatible with EU freedoms, considering that the taxation of non-residents was merely a *different technique* that was not, however, discriminatory.

In light of more recent ECJ case law,[6] the *Conseil d'Etat* had doubts as to whether this argument could still be

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1. FR: ECJ (Fifth Chamber), 22 Nov. 2018, Case C-575/17, *Sofina SA, Rebelco SA, Sidro SA v. Ministre de l'Action et des Comptes Publics*, EU:C:2018:943, Case Law IBFD.
2. Net income versus gross dividends.
3. 33% for resident companies versus 25% or a lower rate under an applicable tax treaty for non-residents.
4. BE: ECJ, 22 Dec. 2008, Case C-282/07, *Belgian State v. Truck Center SA*, EU:C:2008:762, Case Law IBFD.
5. FR: *Conseil d'Etat* (CE), 9 May 2012, *Société GBL Energy*, Nos. 342221 and 342222, RFJ 7/12 No. 774 ; and FR: CE, 25 Nov. 2015, *Kermadec II*, No. 373128, RFJ 2/16, No. 139.
6. NL: ECJ, 17 Sept. 2015, Joined Cases C-10/14, C-14/14 and C-17/14, *Miljoen, X, Société Générale SA v. Staatssecretaris van Financiën*, EU:C:2015:608, Case Law IBFD.

relied upon and decided to refer the following questions to the ECJ:

(1) Must Articles [63 and 65 TFEU] be interpreted as meaning that the cash-flow disadvantage resulting from the application of withholding tax to dividends paid to loss-making non-resident companies, while loss-making resident companies are not taxed on the amount of the dividends they receive until the year when, if at all, they return to profitability, constitutes in itself a difference in treatment characterising a restriction on the free movement of capital?

(2) Must the potential restriction on the free movement of capital referred to in the preceding question, in view of the requirements resulting from Articles [63 and 65 TFEU], be regarded as being justified by the need to ensure the effective collection of tax, since non-resident companies are not subject to the supervision of the French tax authorities, or by the need to safeguard the allocation of the power to impose taxes between the Member States?

(3) If application of the withholding tax at issue may in principle be accepted with regard to the free movement of capital:

- Do those provisions preclude the collection of withholding tax on dividends paid by a resident company to a loss-making non-resident company of another Member State where the latter ceases to trade without returning to profitability, while a resident company placed in that situation is not in fact taxed on such dividends?
- Must those provisions be interpreted as meaning that where taxation rules apply which treat dividends differently depending on whether they are paid to residents or non-residents, it is appropriate to compare the actual tax burden borne by each of them in respect of those dividends, so that a restriction on the free movement of capital resulting from the fact that those rules preclude for non-residents alone the deduction of expenses which are directly linked to the actual receipt of the dividends may be regarded as being justified by the difference in the rate of tax between the general tax payable in a subsequent year by residents and the withholding tax levied on dividends paid to non-residents, where that difference compensates, with regard to the amount of tax paid, for the difference in the taxable base?

3. The ECJ's Decision

In its decision, the Court followed Advocate General Wathelet's analysis,[7] concluding that the French withholding tax violated the freedom of capital movement. The Court began by clearly setting out the different treatment of resident and non-resident taxpayers under the French legislation: while the tax imposed on dividends paid to non-residents was "immediate and definitive", the taxation of residents receiving the same dividends was contingent on their "net-loss making or net-profit making".[8] As a result, resident taxpayers benefit, first, from a cash-flow advantage and, second, from uncertainty in terms of whether there will be any tax levied on those dividends in the future.[9]

In explaining that the assessment of whether a less favourable treatment exists has to be made for each tax year individually,[10] the Court held that, for loss-making taxpayers, in the year of receiving the dividends, both the cash-flow disadvantage and the contingency amounted to restrictions of the free movement of capital.[11]

Even before formally considering possible justifications for these disadvantages, the Court made it plain that the French government could not rely on the lower tax rate applied to dividends paid to non-residents: first, the lower French rate did not prevent Belgium from levying additional tax;[12] second, the potential existence of other advantages cannot compensate for established disadvantages;[13] third, the lower tax rate is irrelevant in circumstances in which residents benefit from a de facto exemption due to their definitive loss situation.[14]

The ECJ then repeated its long-standing jurisprudence that a restriction of the free movement of capital can only be justified by a lack of objective comparability or the existence of an overriding reason in the public interest, before considering comparability and two such potential grounds of justification.[15]

On comparability, the Court first examined the French government's argument,[16] based on the ECJ's *Truck Center* (Case C-282/07) decision, namely that the withholding tax imposed on non-residents merely took into account the different situations of residents and non-residents with respect to France's capacity to collect taxes. The Court gave short shrift to this position, distinguishing *Truck Center* from the case at hand on the grounds that the taxation of residents was not in doubt in that case, whereas loss-making resident taxpayers would be exempt in the situation under examination.[17]

On the first justification, based on the allocation of the powers of taxation between the Member States involved, the Court concluded, remarkably, that France was not hindered from granting the same deferral it afforded to residents also to non-residents, noting that:[18]

> the deferral of the taxation of dividends received by a loss-making non-resident company would not mean that the French State has to waive its right to tax income generated on its territory. The dividends distributed by the resident company would, in fact, be subject to taxation once the non-resident company became profitable during a subsequent tax year, in the same way as is the case for a resident company in a similar situation.

7. FR: Opinion of Advocate General Wathelet, 7 Aug. 2018, Case C-575/17, *Sofina SA, Rebelco SA, Sidro SA v. Ministre de l'Action et des Comptes Publics*, EU:C:2018:650, Case Law IBFD.
8. *Sofina and Others* (C-575/17), para. 28.
9. Id.
10. Id., para. 30.
11. Id., para. 34.
12. Id., para. 36.
13. Id., paras. 37-38.
14. Id., para. 38.
15. Id., para. 46.
16. The argument was also supported by the Belgian, German, and UK governments in that case.
17. *Sofina and Others* (C-575/17), paras. 51-52.
18. Id., para. 59.

Acknowledging that such a deferral would result in a loss of tax revenue if the non-resident taxpayer never became profitable again, the Court dismissed that consequence as a mere "reduction in tax revenue [that] cannot be regarded as an overriding reason in the public interest which may be relied on to justify a measure which is, in principle, contrary to a fundamental freedom".[19] This is all the more true, the Court continued, where the Member State accepts that same exemption in respect of resident companies that cease trading without returning to profitability.

On the second justification, based on the need for an effective collection of tax, the Court reiterated its long-standing jurisprudence, upholding the legitimacy of both that ground and the method of retention at source,[20] but ultimately rejected the proportionality of the measure in this case: since the disadvantage stemmed from a denial of a deferral of taxation in a loss situation, the question was merely whether, in this case, a withholding tax was indeed necessary to achieve the aim of the effective collection of tax.[21] The Court denied this, proposing an alternative measure that would be equally effective in addressing France's legitimate concerns about tax collection while preserving the same beneficial deferral of taxation for non-residents as for residents.

Testing the alternative measure, the Court based its conclusion on three arguments:

(1) First, "the rules on the deferral of taxation in the event of losses constitute, inherently, a derogation to the principle of taxation during the tax year in which the dividends are distributed".[22]

(2) Second, "it would be the duty of non-resident companies to provide the relevant evidence to allow the tax authorities of the Member State of taxation to determine that the conditions, laid down in the legislation, for benefiting from such a deferral have been met".[23]

(3) Third, the "mutual assistance mechanisms existing between the authorities of the Member States are sufficient to enable the Member State in which the dividends are paid to check the accuracy of the evidence put forward by the non-resident companies".[24]

The Court, finally, addressed the main practical concern of deferring taxation, namely the possibility to collect a tax on distributed dividends in later years when the non-resident company has returned to profitability. It examined the issue only indirectly, stating that "Article 4(1) of Council Directive 2008/55/EC[25] … allows the Member State in which dividends are paid to obtain, from the Member State of residence, the information necessary to allow it to recover a tax liability which arose when the dividends were distributed".[26]

Consequently, the Court held that the French withholding tax violated the free movement of capital, and saw no need to answer the question concerning the deductibility for tax purposes of expenses directly related to the dividend paid to non-residents.[27]

4. Comments

4.1. Comparability and justification: What about "territoriality"?

This decision has potentially far-reaching consequences for the taxation of cross-border situations and the allocation of taxing rights in the European Union (and beyond) due to its novel interweaving of established doctrine with more progressive stances both on comparability and potential justification of restrictions. To the authors' knowledge, this is the first corporate tax case in which the Court is forcing the source state to take into account losses that are completely unrelated to source state income.

At first glance, the Court's approach to establishing comparability of non-residents and residents appears consistent with its long-standing jurisprudence, according to which non-residents are in a comparable situation to residents with respect to income on which the source state has decided to tax them.[28] However, neither the Advocate General nor the Court made reference to the even longer established territoriality exception to such comparability. Since *Futura*[29] it had been accepted – with a few exceptions related to the subjective ability to pay of individual taxpayers[30] – that non-residents would only ever be in a comparable situation to residents of the source state in

19. Id., para. 61.
20. Id., para. 68.
21. Id., para. 70.
22. Id., para. 71.
23. Id., para. 72.
24. Id., para. 73.
25. Replaced by Council Directive 2010/24/EU of 16 March 2010 concerning mutual assistance for the recovery of claims relating to taxes, duties and other measures, OJ L 84, p. 1 (2010), Primary Sources IBFD.
26. *Sofina and Others* (C-575/17), para. 75.
27. Advocate General Wathelet had concluded, not surprisingly, that such expenses also needed to be deductible in the hands of non-resident companies under the same conditions as for residents.
28. FR: ECJ, 14 Dec. 2006, Case C-170/05, *Denkavit Internationaal BV, Denkavit France SARL v. Ministre de l'Économie, des Finances et de l'Industrie*, EU:C:2006:783, para. 35, Case Law IBFD; UK: ECJ, 12 Dec. 2006, Case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation v. Commissioners of Inland Revenue*, EU:C:2006:773, para. 68, Case Law IBFD; NL: ECJ, 8 Nov. 2007, Case C-379/05, *Amurta SGPS v. Inspecteur van de Belastingdienst/Amsterdam*, EU:C:2007:655, para. 38, Case Law IBFD; IT: ECJ, 19 Nov. 2009, Case C-540/07, *Commission of the European Communities v. Italian Republic*, EU:C:2009:717, para. 52, Case Law IBFD; ES: ECJ, 3 June 2010, Case C-487/08, *European Commission v. Kingdom of Spain*, EU:C:2010:310, para. 51, Case Law IBFD; DE: ECJ, 20 Oct. 2011, Case C-284/09, *Commission of the European Communities v. Federal Republic of Germany*, EU:C:2011:670, para. 56, Case Law IBFD; and NL: ECJ, 17 Sept. 2015, Joined Cases C-10/14, C-14/14 and C-17/14, *Miljoen, X, Société Générale SA v. Staatssecretaris van Financiën*, EU:C:2015:608, para. 67, Case Law IBFD.
29. LU: ECJ, 15 May 1997, Case C-250/95, *Futura Participations SA and Singer v. Administration des contributions*, EU:C:1997:239, Case Law IBFD.
30. *See* LU: ECJ, 18 July 2007, Case C-182/06, *État du Grand-Duché de Luxembourg v. Hans Ulrich Lakebrink, Katrin Peters-Lakebrink*, EU:C:2007:452, Case Law IBFD; NL: ECJ, 16 Oct. 2008, Case C-527/06, *R.H.H. Renneberg v. Staatssecretaris van Financiën*, EU:C:2008:566, Case Law IBFD; NL: ECJ, 9 Feb. 2017, Case C-283/15, *X v. Staatssecretaris van Financiën*, EU:C:2017:102, Case Law IBFD; *see also* CFE ECJ Task Force, *Opinion Statement ECJ-TF 4/2017 on the Decision of the Court of Justice of the European Union of 9 February 2017 in* X *(Case C-283/15) ("Pro-Rata Personal Deductions"), Concerning Personal and Family Tax Benefits in Multi-State Situations*, 58 Eur. Taxn. 4 (2018), Journal Articles & Papers IBFD.

respect of their income derived from activity in that state. Faced with a tax system where "for the purpose of calculating the basis of assessment for non-resident taxpayers, only profits and losses arising from their [source state] activities are taken into account in calculating the tax payable by them in that State",[31] the Court concluded in that decision that: "Such a system, which is in conformity with the principle of territoriality, cannot be regarded as entailing any discrimination, overt or covert, prohibited by the Treaty".[32] The Court later affirmed and generalized that result, holding in *Centro Equestre* that it was "clear from the Court's case law that a tax system under which, for the purposes of calculating the basis of assessment for non-resident taxpayers in a particular Member State, only profits and losses arising from their activities in that State are taken into account is consistent with the principle of territoriality enshrined in international tax law and recognised by Community law".[33]

The Court, in *Sofina*, deviated from that precedent without any acknowledgment of its decisions in *Futura* and *Centro Equestre* and suggested that comparability derived from the source state's unilateral decision to tax a particular stream of income of a non-resident extends to the entirety of the taxpayer's activities. That result, while compatible with the wording of the cited precedents in *Commission v. Germany*[34] and *Miljoen* (Joined Cases C-10/14, C-14/14 and C-17/14),[35] which do not explicitly distinguish between a particular stream of income and the entirety of a person's income ("as soon as a Member State … imposes a charge to tax *on the income*, … the situation of those non-resident taxpayers becomes comparable to that of resident taxpayers"). Nevertheless it upends the traditional understanding of those precedents as concerns equal treatment of non-residents with residents, further blurring the line on the relevance of the territorial boundaries commonly drawn under international tax law. The decision could be regarded as an outlier, since the precedents on territoriality seemingly were not referred to in domestic proceedings[36] nor – as far as one can see from the Advocate General's Opinion and the decision – before the ECJ.

What is important, however, is that the Court did not "revive" the territoriality exception as a justification ground either. Instead, it dismissed the claim based on the "balanced allocation of taxing rights" – often considered a version of the territoriality argument at the justification level. This is remarkable: The Court rejects the argument that France's taxing rights would be affected even in a situation in which it could not levy any tax on the dividends paid from profits created by a resident company, since it would accept the same non-taxation result for dividends paid to a (loss-making) resident company. While this reasoning is logically coherent, the outcome is difficult to reconcile with earlier decisions, such as *National Grid Indus* (Case C-371/10), wherein the Court upheld a Member State's right to impose a tax on (streams of) income generated within its territory even in situations in which the taxpayer would not have to pay such a tax if he were a resident.[37] There, the Court held that a Member State was "entitled to tax the economic value generated by an unrealised capital gain in its territory even if the gain has not yet actually been realised".[38] Even more strikingly, it suggests a stricter obligation on the source state to take into account foreign losses than the *Marks & Spencer* jurisprudence imposes on residence states.[39]

It is unclear if the Court intended to put this well-established ground of justification into serious doubt. There are three possible ways of reading this point: (i) it is an "outlier" decision unlikely to have an impact in future cases; (ii) the Court's conclusions in *Sofina* are limited to the concrete case of (dividend) withholding taxes in the specific context in which the parent company has losses and the domestic law (of France) is intended to pursue a specific goal of neutrality; or (iii) the Court has changed course concerning the comparability analysis by taking into account the overall ability to pay of the non-resident taxpayer.

It is further noteworthy that the Court did not (and perhaps was not asked to) consider the justification of the coherence of the tax system. France could have argued that the disadvantage resulting from disregarding the foreign losses was necessary to maintain the coherence of its tax system, as it would also not take into account profits derived from foreign activities. The ECJ has consistently accepted this argument, which boils down to a claim of corresponding advantages directly linked to the disadvantage imposed on the taxpayer,[40] in considering the residence state's right to deny a deduction of foreign losses.[41] In *Sofina*, the Court did not consider that argument, but instead addressed the possible relevance of compensating advantages before justification grounds – evoking (without explicitly labelling it thus) its "neutralization" doctrine developed in its case law from *Amurta* (Case C-379/05)[42] to *Société Générale* (Case C-17/14).[43] The

31. *Futura* (C-250/95), para. 21.
32. *Futura* (C-250/95), para. 22.
33. DE: ECJ, 15 Feb. 2007, Case C-345/04, *Centro Equestre da Leziria Grande Lda v. Bundesamt für Finanzen*, para. 22, Case Law IBFD.
34. *Commission v. Germany* (C-284/09).
35. As well as the case law referenced therein. *See supra* n. 28.
36. FR: CE, 20 Sept. 2018, Case Nos. 398662, 398663, 398666, 398672, 398674 and 398675, *Sofina, Rebelco, Sidro.*
37. NL: ECJ, 29 Nov. 2011, Case C-371/10, *National Grid Indus BV v. Inspecteur van de Belastingdienst Rijnmond/kantoor Rotterdam*, paras. 44-49, Case Law IBFD. *See also* CFE ECJ Task Force, *Opinion Statement of the CFE on the Decision of the European Court of Justice of 29 November 2011 in Case C-371/10,* National Grid Indus BV *and Business Exit Taxes within the European Union*, 53 Eur. Taxn. 6 (2013), Journal Articles & Papers IBFD.
38. *National Grid Indus* (C-371/10), para. 49.
39. *See further* sec. 4.3.
40. Where, at least since FI: ECJ, 7 Nov. 2013, Case C-322/11, *K*, Case Law IBFD, the fact that an advantage and disadvantage concern the same taxpayer and the same tax seem to be considered sufficient for the Court to consider such "direct link" to be established. *See K* (C-322/11), para. 70.
41. *See*, for example, *K* (C-322/11), para. 71.
42. *Amurta* (Case C-379/05).
43. *See* CFE ECJ Task Force, *Opinion Statement ECJ-TF 1/2016 on the Decision of the European Court of Justice in Joined Cases* Miljoen *(Case C-10/14),* X *(Case C-14/14) and* Société Générale *(Case C-17/14) on the Netherlands Dividend Withholding Tax*, 56 Eur. Taxn. 6 (2016), Journal Articles & Papers IBFD.

Court's first point made in this context – that the reduced withholding tax under the Belgium-French Income Tax Treaty (1964)[44] did not limit Belgium's right to tax[45] – can probably be regarded as extraneous to its decision since it is difficult to imagine that the Court would have found otherwise had the treaty allocated an exclusive taxing right to France.

The Court's analysis of the proportionality of retention at source is also interesting. It is notable that it did not explicitly mention "proportionality" in the decision, but seemingly imbeds the conditions of that test in the prerequisites for the legitimacy of the "effective collection of tax" as a justification ground.[46] In substance, the Court undertakes the steps traditionally viewed as part of the proportionality test, analysing the suitability and necessity of the restrictive measure to achieve a legitimate aim. Unusually, however, the decision's focus is not on the appropriateness of the measure implemented by France but on the suitability of an alternative system of taxation, where the source state would (i) defer collection of withholding tax for loss-making non-resident companies and (ii) subsequently collect that tax if and when such companies become profitable. The Court concluded that replacing the existing withholding tax system with an alternative collection mechanism "would not undermine the achievement of … the effective collection of tax",[47] making three separate arguments in favour of such an alternative.

First, the fact that, for the majority of companies, deferral would be granted in the presence of losses showed that the purported aim of immediate collection of tax could not be all that fundamental to France. This argument essentially concerns the suitability of France's withholding tax system to contribute to a *legitimate* aim. The Court implicitly appears to demand consistency in Member State policies, which France had undermined through its liberal approach to domestic dividend taxation.

Second, under the Court's alternative, non-resident companies would need to prove that they are in the same situation as resident companies who do not bear a tax in order to benefit from deferral of taxation. The Court thus indicates that the burden would entirely fall on non-resident companies to prove that they are loss-making in a given year. The focus appears to be to show that such an alternative mechanism would not be unduly burdensome for the Member State; it does not address the question of how, exactly, a taxpayer would provide such proof.[48]

Third, the Court pointed to the ability of the source state to rely on administrative assistance enshrined in the EU Mutual Assistance Directive (2011/16)[49] in order to verify the proof provided by the taxpayer. It backed that argument further with a reference to Directive 2008/55/EC on the recovery of claims. In the Court's estimation, the existence of these instruments made it unnecessary and thus disproportionate to apply a withholding tax on outbound dividends in all circumstances – from the perspective of the legitimate aim to collect taxes. The decision did not address the practical difficulty of following up on eventual profits made by a non-resident company in the years after their successful claim not to levy withholding tax. The Court seems to assume that the Member State from which the dividends originated will be able to rely on information given by the Member State of residence. In contrast to the necessary proof the taxpayer has to provide for losses when bringing a claim, however, at that stage the taxpayer has little incentive to instigate this, leaving open the question of who exactly is going to undertake the task of recalculating such eventual profits in accordance with the source state's tax rules if it becomes necessary (which the French *Conseil d'État* does not see as being the case).[50]

4.2. Implementation of the decision

The decision did not address how the taxpayer's overall loss position ought to be determined. This issue was not raised in *Sofina* (presumably because the taxpayers had a deficit under both States' rules), but it would seem logical to apply the source state's rules to avoid unequal treatment.[51] Needless to say, calculating a foreign corporation's worldwide income under source state rules may, at a minimum, be a nuisance for taxpayers and administrations alike, in particular since it would have to be done each year to determine if the company is finally profitable with the result that losses could be recaptured.[52] The *Conseil d'État*, however, took a different approach in its

44. *Convention between Belgium and France for the Avoidance of Double Taxation and the Establishment of Reciprocal Rules of Administrative and Judicial Assistance in Respect of Taxes on Income* (10 Mar. 1964), Treaties & Models IBFD.
45. *Sofina and Others* (C-575/17), para. 36.
46. Id., para. 67.
47. Id., para. 70.
48. *See* sec. 4.2.
49. Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation and repealing Directive 77/799/EEC, OJ L 64 (2011), Primary Sources IBFD.
50. *See further* sec. 4.2.
51. *See*, for the reverse situation, i.e. from the residence state's perspective, for example, FI: ECJ, 21 Feb. 2013, Case C-123/11, *A Oy*, EU:C:2013:84, paras 57-61, Case Law IBFD and even more pronounced, FI: Opinion of Advocate General Kokott, 19 July 2012, Case C-123/11, *A Oy*, EU:C:2012:488, paras. 70-76, especially para. 73, Case Law IBFD: "In my view, the reply to the second question should then be that the losses to be taken into account must *in principle* be calculated according to the tax law of the receiving company's State of residence. As the French Government also submitted, only in that way would calculation of the losses lead to equal treatment in cases within a single Member State and in cross-border situations, that is to say, a merger with a resident subsidiary and a merger with a foreign subsidiary would receive equal treatment for tax purposes. Equal treatment in that way would remove the restriction of the freedom of establishment which, as we have seen, arises precisely from the different treatment of the two situations".
52. At least two likely practical problems appear noteworthy: First, timing. The final tax assessment in the company's residence Member State for the relevant year in which dividends are received and withholding tax applied will typically only be available at a later moment in time. Second, recalculation. Providing a certified tax assessment from the residence Member State will likely not suffice, but taxpayers will have to provide a verifiable recalculation of their tax result in accordance with the (each!) source state's tax rules. It is not obvious which authority can even properly verify that recalculated result, since this requires knowledge of both the facts and the law in both relevant jurisdictions. Would it be proportionate to require companies to undergo a joint audit by the residence and source state authorities?

follow-up decision,[53] relying instead on a loss determined under Belgian law (state of residence of the taxpayer).

In any event, as the Court points out, it is up to the non-resident company to provide proof of its overall loss position. It is up to Member States to develop the administrative procedure to process such claims. Presumably, it will be sufficient for the source state to provide a refund of withholding tax only ex post, once proper proof has been provided by the taxpayer.

The Court's concern in *Sofina* was for (overall) loss-making companies. The same issues arise, however, in respect of the levying of withholding taxes on non-residents with losses that do not exceed the dividends received. In the equivalent situation, a resident recipient would only pay tax on a portion of the dividends[54] – but the rest is deferred just as in an overall loss situation. The situation is therefore essentially the same.

Finally, the implementation of the Court's preferred alternative to France's dividend withholding tax may run counter to bilateral tax treaties. The Court assumed that France could, at any point, collect taxes from non-resident companies once they become profitable again. Yet, under bilateral tax treaties, source states are only entitled to impose a tax on distributed dividends and not on profits of non-resident companies stemming from other activities. While this is unlikely to be an insurmountable obstacle, it will require a careful legislative response from Member States, for example, to ensure that any later charge would be construed merely as the collection of the initial tax liability and not as a tax in its own right on subsequent emerging profits.

4.3. Wider implications

The decision in *Sofina* renews doubts concerning the role of the "balanced allocation of taxing powers" justification ground in general[55] and the continued application of the "definitive loss doctrine", in particular. This doctrine, which is both long-established and continuously upheld – as well as much-criticized from within the Court[56] – is in marked tension with the latest decision. The Court's dismissal of the justification of a balanced allocation in *Sofina* appears to be difficult to reconcile with that doctrine, which – in the reverse case of an overall loss arising from a company's activity in the source state – allows Member States to tax a resident company on its domestic positive income immediately and in full, disregarding the (cash-flow) disadvantage to the taxpayer. While this tension was already present in the juxtaposition between the *Marks & Spencer* and the *Schumacker* lines of case law, especially looking at *Lakebrink* (Case C-182/06)[57] and *Renneberg* (Case C-527/06),[58] it was possible to distinguish those lines on the ground that the latter exclusively concerned individuals, the personal circumstances of which the Court seemed to afford special consideration not available to companies. In *Sofina*, the positions seem almost reversed: while the Court held that individual taxpayers (in *Schumacker* to *X* (Case C-283/15))[59] are not comparable with regard to their foreign income except to the extent that their residence state could not fully take into account their personal circumstances, it seemed to accept automatic comparability for all of a non-resident company's activities even where the source state exercises only a very limited taxing jurisdiction over a small part of the non-resident's income. While the decision thus appears, finally, to bring the tension between the different lines of case law into the open, the Court did not address it.

As a result (simplifying the matter somewhat), there appear to be three different approaches to the treatment of foreign losses: first, following the *Marks & Spencer* case law, losses arising outside a company's residence state can only be "transferred" if they cannot be taken into account anywhere else; second, following the *Schumacker-Renneberg* case law applicable to individuals, losses arising outside a source state may be *partially* "transferred" if they cannot be taken into account in the residence state; third, following *Sofina*, losses arising outside a source state may be "transferred" (at least temporarily) and lead to a deferral of taxation to the extent that a resident's tax liability would be lower had he incurred the same losses in the source state.

It must be noted that the implications of the decision may go beyond intra-EU situations: although the Court has acknowledged that investments from third countries take place in a "different legal context"[60] by reason of the presence of secondary law governing the cooperation of tax administrations in Member States, the significance of this difference disappears where such cooperation with third countries is ensured by other means, such as a bilateral or multilateral treaty.[61]

Although this may be a smaller concern from an EU tax law perspective, preventing the source state from imposing a tax on positive domestic income has the potential, fundamentally, to upset the allocation of taxing rights decided upon under most bilateral tax treaties: under the "Authorized OECD Approach", a state in which a company has established a permanent establishment (PE)

53. FR: CE, 27 Feb. 2019, No. 398662, FR:CECHR:2019:398662.20190227 – *Sofina*.
54. Consider the following example: a company has operating losses of 100 and receives 120 in dividends. A non-resident would be subject to a 15% withholding tax on 120, amounting to 18. A resident would bear corporate tax of 33% on 20 (120-100), amounting to only 6.6. The remaining tax liability on the dividends is deferred to future profit-making years by virtue of the eliminated loss carry-forward.
55. *See* comments *supra* sec. 4.1.
56. *See*, for example, AG Opinion in *A Oy* (C-123/11), paras. 47-54; FI: Opinion of Advocate General Mengozzi, 21 Mar. 2013, Case C-322/11, *K*, EU:C:2013:183, paras 63-89, Case Law IBFD; UK: Opinion of Advocate General Kokott, 23 Oct. 2014, Case C-172/13, *European Commission v. United Kingdom of Great Britain and Northern Ireland*, EU:C:2014:2321, paras. 49-53, Case Law IBFD; and DE: Opinion of Advocate General Wathelet, 3 Sept. 2015, Case C-388/14, *Timac Agro Deutschland GmbH v. Finanzamt Sankt Augustin*, EU:C:2015:533, para. 66, Case Law IBFD.
57. *Lakebrink* (C-182/06).
58. *Renneberg* (C-527/06).
59. *X* (C-283/15); *see also* CFE ECJ Task Force, *supra* n. 31, at pp. 163-169.
60. *See* ECJ, 18 Dec. 2007, Case C-101/05, *Skatteverket v. A*, EU:C:2007:804, para. 36, Case Law IBFD.
61. *See*, by analogy, AT: ECJ, 10 Feb. 2011, Joined Cases C-436/08 and C-437/08, *Haribo Lakritzen Hans Riegel BetriebsgmbH and Österreichische Salinen AG v. Finanzamt Linz*, para. 73, Case Law IBFD.

is entitled to tax profits attributable to that PE irrespective of the overall situation of the taxable entity. Taking the Court's decision in *Sofina* at face value, companies may be entitled to oppose such a tax charge on the grounds that they would not have to bear it if they were resident companies. This, in turn, would potentially (re)introduce a significant difference in taxation – in the source state – of PEs and subsidiaries. Since that difference would be in favour of non-residents, it would not, however, amount to a restriction of the fundamental freedoms. The same may be relevant in the context of a transfer of assets from the PE to the Head Office within the framework of the exit taxation rules under the ATAD (2106/1164).[62]

5. The Statement

CFE Tax Advisers Europe note that the Court's decision in *Sofina* may have extended the standard of comparability, requiring one to take into consideration the (foreign) non-dividend income of the recipient in comparing the tax treatment of domestic and outbound dividends. This comparator, however, upsets the principle of territoriality, as accepted by the Court in *Futura* and *Centro Equestre*, by requiring the source state to take into account losses that the non-resident taxpayer has in the residence state.

Taken at face value, *Sofina*'s impact may extend well beyond withholding taxes specifically and dividend taxation more generally by attaching a "no-loss" condition to all source state taxing rights. It may arguably even bar the PE state from taxing profits attributable to that PE if the foreign head office is in a loss position.

Moreover, applying *Sofina* to everyday international tax law might also not be an easy task and may push administrative feasibility to its limits. The Court effectively seems to propose a non-discriminatory deferral of taxation in combination with a domestic regime that leads to a subsequent recapture if (and only if) the non-resident taxpayer becomes profitable during a subsequent tax year.

62. Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, [2016] OJ L 193/1, Primary Sources IBFD.