# OPINION OF ADVOCATE GENERAL KOKOTT

delivered on 12 September 2006 [1]

## I — Introduction

1. This reference for a preliminary ruling from the Korkein hallinto-oikeus (Supreme Administrative Court, Finland) concerns provisions of the Konserniavutuksesta verotuksessa annettu laki (Law on Intra-group Financial Transfers). They provide that intra-group transfers are transfers within a group, either by a parent to a subsidiary company or by a subsidiary to a parent company. Intra-group transfers are deducted from the taxable business income of the transferor company and are regarded as taxable business income of the transferee company. However, only intra-group transfers between Finnish share companies are deductible.

2. The basic purpose of this Finnish provision is to put groups consisting of parent and subsidiary companies in the same position as a firm which has a number of permanent establishments. In order to achieve this purpose, a transfer between companies in the same group is taxed only once, being deducted from the taxable income of the company which provides it and added to the taxable income of the recipient company.

3. Thus, this tax treatment of intra-group transfers allows a taxable profit made by one group company to be used to offset a loss made by another group company, thereby allowing those profits to avoid being taxed.

4. Accordingly, the present facts are comparable with those in *Marks & Spencer*. [2] In that case United Kingdom law permitted one to 'transfer' a loss made by one company to the profits of another company within the same group in order to reduce the tax on

1 — Original language: German.

2 — Case C-446/03 [2005] ECR I-10837.

those profits. The present case is the reverse, namely the profits of a company being 'transferred' against the loss of another company.

5. The Community law problem which arises in both cases is that cross-border groups are excluded from this tax advantage. In *Marks & Spencer* the Court regarded this as a restriction on freedom of establishment which was, however, justified, except where a loss sustained abroad could not otherwise be taken into account for tax purposes. It supported the justification by considering three factors together, namely protecting a balanced allocation of the power to impose taxes between the different Member States concerned, avoiding losses being taken into account twice, and preventing tax avoidance.

6. Accordingly, the issue to be determined in the present proceedings is the extent to which the principles the Court laid down in *Marks & Spencer* may be applied to the present circumstances. The question also arises as to the importance of the principle of cohesion of the tax system, which the Court did not consider in *Marks & Spencer*.

## II — Legal framework

A — *Community law*

7. Article 4(1) of Directive 90/435/EEC[3] provides:

'1. Where a parent company or its permanent establishment, by virtue of the association of the parent company with its subsidiary, receives distributed profits, the State of the parent company and the State of its permanent establishment shall, except when the subsidiary is liquidated, either:

— refrain from taxing such profits, or

— tax such profits while authorising the parent company and the permanent establishment to deduct from the amount of tax due that fraction of the corporation tax related to those profits and paid by the subsidiary and any lower-tier subsidiary, subject to the condition that at each tier a company and its lower-tier subsidiary meet the

3 — Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (OJ 1990 L 255, p. 6), as amended by Council Directive 2003/123/EC of 22 December 2003 amending Directive 90/435/EEC (OJ 2004 L 7, p. 41).

requirements provided for in Articles 2 and 3, up to the limit of the amount of the corresponding tax due.'

B — *National law*

8. Articles 1 to 5 of the Konserniavutuksesta verotuksessa annettu laki 825/1986 ('the KonsAvL') provide:

'1. This law governs the deduction of an intra-group financial transfer from the taxable income of the transferor and the assimilation of that transfer to income in the hands of the transferee.

2. The expression "intra-group financial transfer" means any transfer made by a company limited by shares, or by a cooperative company which carries on a business, for the purposes of the business of another company limited by shares or cooperative company, which is not an investment of capital, not deductible from income pursuant to the Law on Taxation of Business Income [elinkeinotulon verottamisesta annettu laki (360/1968)].

3. If a national company limited by shares or a cooperative company (the parent company) holds at least nine tenths of the capital of another national company limited by shares, or of the shares of another national cooperative company (the subsidiary), the parent company may deduct the intra-group financial transfer made in favour of its subsidiary from its taxable business income. The amount of the intra-group transfer made is assimilated to income arising from a taxable business activity of the subsidiary.

The term "subsidiary" also covers companies limited by shares or cooperative companies whose parent company holds at least nine tenths of the capital or shares together with one or more other subsidiaries.

The provisions of paragraph 1 also apply to an intra-group financial transfer by the subsidiary in favour of the parent company or of another subsidiary of the parent company.

4. An intra-group financial transfer is treated for tax purposes as an expense of the transferor and income of the transferee for the tax year in which the transfer is made.

5. Taxable persons are entitled to deduct intra-group transfers which they have made as expenses only if the corresponding expense and income are entered in the accounts of the transferor and transferee concerned.'

## III — Facts and procedure

9. Oy AA has its establishment in Finland and is part of the AA group, the parent company of which is AA Limited, a company whose establishment is in England and which owns 100% of the shares in Oy AA through two intermediate companies resident in the Netherlands. [4]

10. Unlike AA Limited, Oy AA has made profits in the last few years. AA Limited's business activity being important for Oy AA, consideration was given as to whether AA Limited's operations should be supported by a transfer from Oy AA. Accordingly, Oy AA applied to the Keskusverolautakunta (Central Tax Commission) for a preliminary decision on whether such a transfer would constitute an intra-group transfer for the purposes of Article 3 of the Law on Intra-group Financial Transfers.

11. In its preliminary decision for the tax years 2004 and 2005 the Keskusverolautakunta held that a transfer by Oy AA to AA Limited was not an intra-group transfer within the meaning of the Law on Intra-group Financial Transfers and accordingly that it was not deductible expenditure from Oy AA's assessment to corporation tax, on the ground that AA Limited was a non-resident company.

4 — At their request the companies have been granted anonymity.

12. By order dated 23 May 2005, the Korkein hallinto-oikeus, which is hearing Oy AA's appeal against the preliminary decision, stayed the proceedings and referred the following question to the Court for preliminary ruling pursuant to Article 234 EC:

'Do Articles 43 EC 56 EC, having regard to Article 58 EC and Directive 90/435 ..., preclude the system established by the Finnish Law on Intra-Group Financial Transfers, which makes the deductibility of intra-group financial transfers subject to the condition that the transferor and the transferee be national companies?'

## IV — Legal analysis

13. It must first be observed that Directive 90/435 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States is not relevant to the decision in the present case. This directive provides for the tax treatment of profit distributions to a parent company by a subsidiary company resident in a different Member State.

14. However, the present case does not concern the distribution of profits by a subsidiary company to its direct parent company, but a payment by a company of untaxed income to a group holding company having only an indirect interest in it. Moreover, the directive provides only for the tax treatment of the distribution in the hands of the parent company, and not for the tax consequences of the distribution so far as the subsidiary is concerned.

15. Furthermore, it must be borne in mind that, according to the settled case-law of the Court, although direct taxation as such does not fall within the competence of the Community, Member States must none the less exercise the competence they retain consistently with Community law. [5]

16. Finally, it must be recalled that in principle, freedom of establishment and free movement of capital, both of which form part of the subject-matter of the reference, may be applicable in parallel. [6] As I explained in my Opinion in the case of *Bouanich*, [7] neither of the fundamental freedoms ousts the other. However, the Court has approached cases which have fallen within the scope of application of both fundamental freedoms sometimes by giving precedence to free movement of capital, [8] and sometimes by giving precedence to freedom of establishment. [9]

17. Thus, in *X and Y* the Court explained that free movement of capital did not have any independent effect in circumstances where a provision fell within the scope of application of freedom of establishment, given that the issue concerned the acquisition of a shareholding which gave a controlling influence over the decisions of the undertaking in question. [10]

5 — *Marks & Spencer* (cited above, footnote 2), paragraph 29; Cases C-397/98 and C-410/98 *Metallgesellschaft and Others* [2001] ECR I-1727, paragraph 37; Case C-319/02 *Manninen* [2004] ECR I-7477, paragraph 19; and Case C-470/04 *N* [2006] ECR I-7409, point 33.

6 — Case C-302/97 *Konle* [1999] ECR I-3099, paragraph 22.

7 — Case C-265/04 [2006] ECR I-923, at point 71. See also the Opinion of Advocate General Alber in Case C-251/98 *Baars* [2000] ECR I-2787, point 12 ff., with further references, and the Opinion of Advocate General Geelhoed in Case C-524/04 *Test Claimants in the Thin Cap Group Litigation*, point 35.

8 — See for example the 'golden shares' cases, namely Case C-367/98 *Commission* v *Portugal* [2002] ECR I-4731, Case C-483/99 *Commission* v *France* [2002] ECR I-4781, and Case C-503/99 *Commission* v *Belgium* [2002] ECR I-4809, as well as Case C-463/00 *Commission* v *Spain* [2003] ECR I-4581 and Case C-98/01 *Commission* v *United Kingdom* [2003] ECR I-4641. See also the Opinion of Advocate General Poiares Maduro in Joined Cases C-282/04 and C-283/04 *Commission* v *Netherlands*, point 41.

9 — See *Baars* (cited above, footnote 7), Case C-436/00 *X and Y* [2002] ECR I-10829, and Case C-471/04 *Keller Holding* [2006] ECR I-2107.

10 — *X and Y* (cited above, footnote 9), paragraphs 37 and 66. See also the Opinion of Advocate General Léger in Case C-196/04 *Cadbury Schweppes and Cadbury Schweppes Overseas*, point 32.

18. It appears to me to be appropriate to consider first which fundamental freedom is at the heart of the case having regard to the purpose of the relevant national provisions and the facts of the main proceedings. [11]

19. The main proceedings concern the application of the Law on Intra-group Financial Transfers to the transfer of finance from one company to another company which indirectly owns 100% of the shares in the transferor company. On the one hand, the transfer of finance does not serve the acquisition of share capital. However, the transfer is effected by a subsidiary to the parent company which controls it and is thus made in connection with the exercise of freedom of establishment by the parent company.

20. Specifically, the purpose of an intra-group transfer is to balance out profits and losses within the group, which consists of a number of companies. The structure of the group, which extends to a number of Member States, was established in exercise of freedom of establishment. It follows that the essence of the case concerns freedom of establishment and not free movement of capital, notwithstanding that the external form of the transaction is a cross-border flow of capital.

A — *Restriction on freedom of establishment*

21. Freedom of establishment as guaranteed by Article 43 EC recognises the right of nationals of Member States to take up and pursue in another Member State activities as self-employed persons, and to form and manage undertakings, on the same conditions as those laid down for nationals. Pursuant to Article 48 EC, freedom of establishment includes the right of companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community, to pursue their activities in the Member State concerned through a subsidiary company, branch or agency. [12]

22. According to settled case-law, Article 43 EC precludes any national measure which, even though it is applicable without discrimination on grounds of nationality, is liable to hinder or render less attractive the exercise by Community nationals, including nationals of the Member State which enacted the measure, of the freedom of establishment that is guaranteed by the EC Treaty. [13]

11 — To similar effect, see the Opinion of Advocate General Alber in *Baars* (cited above, footnote 7), points 32 to 34, who thinks the distinction should be according to which fundamental freedom is directly affected and which is indirectly affected. In his Opinion in *Test Claimants in the Thin Cap Group Litigation* (cited above, footnote 7), point 35, Advocate General Geelhoed took the same approach.

12 — See Case C-264/96 *ICI* [1996] ECR I-4695, paragraph 20; Case C-307/97 *Saint-Gobain ZN* [1999] ECR I-6161, paragraph 34; *Marks & Spencer* (cited above, footnote 2), paragraph 30; and *Keller Holding* (cited above, footnote 9), paragraph 29.

13 — Case C-55/94 *Gebhard* [1995] ECR I-4165, paragraph 37; Case C-19/92 *Kraus* [1993] ECR I-1663, paragraph 32; and Case C-140/03 *Commission* v *Greece* [2005] ECR I-3177, paragraph 27.

23. The Law on Intra-group Financial Transfers provides that only transfers by Finnish companies to parent companies which are also resident within the territory are deductible for tax purposes; by contrast, intra-group transfers by Finnish companies to parent companies whose seat is in another Member State are not.

24. In this way transnational groups suffer a disadvantage in comparison with domestic groups. From the parent company's point of view, the discrimination is on the ground of its residence, which for legal persons is the equivalent of discrimination on the ground of nationality. Nor does the infringement fall away when one considers the position of the subject of the disputed national provision, namely Oy AA. The transfer made by it to AA Limited is treated differently from transfers by Finnish companies to related national companies. From the point of view of Oy AA, that involves unequal treatment of the cross-border transaction.

25. This unequal tax treatment is likely to hinder the exercise by non-resident parent companies of their freedom of establishment, because it may dissuade them from establishing subsidiary companies in Finland. Thus, the different tax treatment between intra-group transfers to Finnish parent companies and those provided to parent companies resident in other Member States restricts freedom of establishment within the meaning of Articles 43 EC and 48 EC.

26. Some of the Member States which participated in the proceedings before the Court submitted in substance that subsidiary companies of parent companies resident within the territory and subsidiary companies of parent companies resident abroad were in any event not comparable. This was because parent companies resident abroad were not subject exclusively to Finland's sovereign powers of taxation; accordingly, the latter could not be held responsible for the different treatment which resulted from the parallel exercise of a number of sovereign powers. By this argument the Member States sought to exclude from the scope of application of the fundamental freedoms taxation of cross-border groups which was compatible with international tax law.

27. This approach cannot be adopted. It contradicts the fundamental essence of freedom of establishment as a prohibition on restrictions and discrimination. As such, freedom of establishment requires a comparison of purely internal circumstances with cross-border circumstances and provides that unequal treatment must be justified. Thus, within the scope of application of freedom of establishment it is not competent to regard the crossing of a border as sufficient in itself to preclude the situations from being comparable. For that reason, the

circumstance that a factual situation is subject to a number of sovereign powers, which necessarily arises in cross-border situations, cannot lead to the conclusion that the unequal treatment need not be justified.

28. Accordingly, in *Marks & Spencer* the Court held that, 'in tax law, the taxpayers' residence may constitute a factor that might justify national rules involving different treatment for resident and non-resident taxpayers. However, residence is not always a proper factor for distinction. In effect, acceptance of the proposition that the Member State in which a company seeks to establish itself may freely apply to it a different treatment solely by reason of the fact that its registered office is situated in another Member State would deprive Article 43 EC of all meaning'. [14]

29. The United Kingdom Government supported the view that domestic and cross-border groups were not comparable by reference also to the case of *Schempp*. [15] The dispute in that case was whether Mr Schempp's maintenance payments to his former wife were deductible for tax purposes. The relevant German provision allowed the spouse who provided maintenance to deduct the payments if the payments were taxable in the hands of the spouse entitled to maintenance, which in Germany they were. However, in Austria, where Mr Schempp's former wife resided, such payments were not taxable.

30. The Court held that the refusal to allow Mr Schempp to deduct the payments made to his wife in Austria did not constitute discrimination which infringed Article 12 EC. This was because the unfavourable treatment complained of in fact derived from the circumstance that the tax system applicable to maintenance payments in the Member State of residence of Mr Schempp's former spouse differed from that applied in his own Member State of residence. [16]

31. By contrast, the disputed Finnish provisions on intra-group transfers do not refer to the tax treatment of the payments in their recipient's State of residence. Instead, intra-group transfers are deductible only if paid to Finnish group companies. How a national provision which depended not on where the recipient company had its seat but on whether the corresponding expenditure in that company's State of residence was taxable would fall to be assessed is not the subject of the present proceedings.

14 — *Marks & Spencer* (cited above, footnote 2), paragraph 37, under reference to Case 270/83 *Commission* v *France* [1986] ECR 273, paragraph 18 — *'avoir fiscal'*.

15 — Case C-403/03 [2005] ECR I-6421.

16 — *Schempp* (cited above, footnote 15), paragraph 32.

B — *Justification of the restriction*

32. A restriction on freedom of establishment is permissible only if it pursues a legitimate objective compatible with the Treaty and is justified by imperative reasons in the public interest. It is further necessary, in such a case, that its application be appropriate to ensuring the attainment of the objective thus pursued and not go beyond what is necessary to attain it. [17] It must also be proportionate within the narrower meaning of that term.

33. The participating governments and the Commission have put forward a variety of justifications. Despite differences in detail as regards terminology and legal classification, in essence the arguments against extending the deductibility of intra-group transfers to companies resident in a different Member State may be summarised as follows:

— it corresponds to the principle of tax cohesion or symmetry that a deduction should be allowed in Finland only if the Finnish treasury has at the same time the right to tax the income in the hands of the recipient company;

— undertakings would be free to choose the State in which they wanted the income to be taxed, and this would undermine the allocation of powers to impose taxes between the Member States;

— because it is not certain that the income will in fact be taxed abroad in the hands of the recipient company, it may be that in certain circumstances the income will be entirely free from tax (double non-taxation, or so-called 'white income').

1. Cohesion of the tax system

34. The Court has recognised in principle that the need to ensure the cohesion of the tax system might justify a restriction on the exercise of the fundamental freedoms guaranteed by the Treaty. [18] However, for an argument based on such justification to succeed, a direct link has to be established between the tax advantage concerned and

17 — *Marks & Spencer* (cited above, footnote 2), paragraph 35; Case C-250/95 *Futura Participations and Singer* [1997] ECR I-2471, paragraph 26; Case C-9/02 *De Lasteyrie du Saillant* [2004] ECR I-2409, paragraph 49; and *N* (cited above, footnote 5), paragraph 40.

18 — Case C-204/90 *Bachmann* [1992] ECR I-249, paragraph 28, and Case C-300/90 *Commission* v *Belgium* [1992] ECR I-305, paragraph 21. See also *Manninen* (cited above, footnote 5), paragraph 42, and *Keller Holding* (cited above, footnote 9), paragraph 40.

the offsetting of that advantage by a particular tax levy. [19] The further condition that the tax advantage and levy must concern one and the same taxpayer [20] appears to have been abandoned by the Court in its judgment in *Manninen.* [21]

35. In practice, the Court has regarded the question as to whether national tax rules which apply only to internal circumstances are justified as depending on whether the restriction is necessary to safeguard cohesion and whether there is good reason for treating domestic and foreign cases differently. [22] As Advocate General Poiares Maduro stated in his Opinion in *Marks & Spencer*, compliance with the principle of cohesion of national tax systems serves to protect the integrity of those systems, whose organisation is a matter for the Member States, provided they do not impede the internal market more than is necessary. [23]

36. If taxpayers who have exercised their fundamental freedoms are in a position comparable to that of taxpayers on whom the national tax system confers an advantage, the national provision must also be applied to cases having a cross-border element, if doing so does not endanger the cohesion of the national system. This is required by the principle of equal treatment, which is inherent in freedom of establishment. [24]

37. The starting point for consideration of the principle of equal treatment is the purpose pursued by the national provision. [25] A measure is not justified if the objective it pursues could be achieved without treating domestic and cross-border cases differently, or if treatment that was not so different could achieve the same purpose.

38. The fundamental purpose of the Law on Intra-group Financial Transfers is to treat a group as an economic unit, that is to put a group consisting of a parent and subsidiary companies in the same position as an undertaking with a number of permanent establishments. Similarly to the group relief

19 — Case C-484/93 *Svensson and Gustavsson* [1995] ECR I-3955, paragraph 18, and *ICI* (cited above, footnote 12), paragraph 29. See also *Manninen* (cited above, footnote 5), paragraph 42, and *Keller Holding* (cited above, footnote 9), paragraph 40.

20 — I criticised the previous case-law on this point in my Opinion in *Manninen* (cited above, footnote 5).

21 — This assessment is shared by Advocate General Geelhoed in his Opinion in *Test Claimants in the Thin Cap Group Litigation* (cited above, footnote 7), point 88.

22 — To this effect see *Manninen* (cited above, footnote 5), paragraphs 45 and 46, and *Keller Holding* (cited above, footnote 9), paragraphs 41 to 43.

23 — Opinion in *Marks & Spencer* (cited above, footnote 2), point 66.

24 — In his Opinion in *Test Claimants in the Thin Cap Group Litigation* (cited above, footnote 7), point 89, Advocate General Geelhoed correctly emphasised that in considering cohesion the Court has not expressly referred to the fundamental principles of non-discrimination.

25 — *De Lasteyrie du Saillant* (cited above, footnote 17), paragraph 67, and *Manninen* (cited above, footnote 5), paragraph 43, and the Opinion of Advocate General Poiares Maduro in *Marks & Spencer* (cited above, footnote 2), point 72.

provisions in dispute in *Marks & Spencer*, the provision enables profits and losses to be set off against one another even though they arise in different legal persons.

39. If a loss made by a company could not immediately be set off against the profit another company has transferred to it, the profit would have to be taxed. The loss of the other group company would have to be carried forward to a subsequent tax year in order to set it off against the company's own profits then. Thus, an intra-group transfer gives groups the cash-flow advantage which an undertaking having a number of permanent establishments has.

40. In order to achieve this purpose, a transfer between companies in the same group is taxed only once, being deducted from the taxable income of the company which provides it and added to the taxable income of the recipient company.

41. As regards the interest in setting off profits and losses of different group companies, in principle cross-border groups are in a position comparable to that of groups which consist of only domestic companies. In principle, therefore, an intra-group transfer should be deductible also where provided to an associated company resident in another Member State.

42. However, this would be consistent with the system only if it were guaranteed that the transfer would be taxed in the hands of the recipient company. Otherwise, a tax advantage might be conferred without being offset by a corresponding burden directly related to it.

43. In this connection the intervening governments emphasise that the Member State within whose territory the transferor company was resident had no influence on the taxation of the recipient company in its State of residence. However, this does not prevent the former State from allowing the transfer to be deducted for tax purposes only if it is proved that the transfer is in fact taxable in the hands of the recipient company. The disputed Finnish provision does not allow for such proof, instead simply refusing a deduction if the transfer is paid to a non-resident company. It thus goes beyond what is necessary to safeguard the cohesion of the national tax system.

44. This conclusion is not gainsaid by the fact that in that case such intra-group transfers are taxed not in Finland but abroad. This is because according to settled case-law reduction in tax revenue 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. [26] It follows that a national provision cannot be regarded as coherent solely on the ground that it prevents a reduction in tax revenue.

45. In conclusion, the restriction on freedom of establishment which arises out of the unequal treatment of payments between Finnish and non-resident group companies on the one hand and payments between Finnish companies on the other is not justified by reasons of safeguarding the cohesion of the tax system. However, there remains to be considered whether other grounds of justification apply, in particular preserving the allocation of powers to impose taxes between the Member States.

2. Preserving the allocation of powers to impose taxes between Member States

46. In *Marks & Spencer* the Court recognised three grounds of justification (*éléments justificatifs*) and concluded from them, 'taken together, ... that restrictive provisions such as those at issue in the main proceedings pursue legitimate objectives which are compatible with the Treaty and constitute overriding reasons in the public interest and that they are apt to ensure the attainment of those objectives'. [27]

47. The three justifications it recognised were:

— preservation of the allocation of the power to impose taxes between Member States;

— the danger that losses would be used twice; and

— the risk of tax avoidance.

48. The formulation cited above already makes it clear that all three elements are closely linked to one another and cannot be viewed in isolation. In this connection preserving the allocation of the power to impose taxes is at the heart of these elements.

26 — *Manninen* (cited above, footnote 5), paragraph 49, and *Marks & Spencer* (cited above, footnote 2), paragraph 44.

27 — *Marks & Spencer* (cited above, footnote 2), paragraph 51.

49. As already mentioned above, at the current stage of development of Community law power to impose direct taxes lies with the Member States.[28] In the absence of harmonisation at Community law level it is likewise a matter for the Member States to lay down criteria for allocating their powers to impose taxes by the conclusion of double taxation conventions or by unilateral measures.[29]

50. For the purposes of the allocation of powers of taxation, it is not unreasonable for the Member States to find inspiration in international practice and the model conventions drawn up by the Organisation for Economic Cooperation and Development (OECD).[30]

51. By taxing resident companies on their worldwide profits and non-resident companies solely on the profits from their activities in that State, the parent company's Member State is acting in accordance with the principle of territoriality enshrined in international tax law and recognised by Community law.[31]

52. In *Marks & Spencer* the Court found that the allocation of power to impose taxes had been jeopardised as follows: '[T]o give companies the option to have their losses taken into account in the Member State in which they are established or in another Member State would significantly jeopardise a balanced allocation of the power to impose taxes between Member States, as the taxable basis would be increased in the first State and reduced in the second to the extent of the losses transferred.'[32]

53. That finding applies *mutatis mutandis* to an extension of the rules in the Law on Intra-group Financial Transfers to cross-border transfers. It would likewise undermine the allocation of powers to impose taxes according to the principle of territoriality if taxpayers had a free choice as to the Member State in which their profits should be taxed, by extracting a company's profits from its tax basis and adding them to the tax basis of a group company established in a different Member State.

28 — See above, point 15.

29 — See Case C-336/96 *Gilly* [1998] ECR I-2793, paragraphs 24 and 30; Case C-385/00 *De Groot* [2002] ECR I-11819, paragraph 93; Case C-376/03 *D* [2005] ECR I-5821, paragraphs 50 and 51; Case C-513/03 *van Hilten-van der Heijden* [2006] ECR I-1957, paragraph 47; and *N* (cited above, footnote 5), paragraphs 43 and 44.

30 — *Futura Participations and Singer* (cited above, footnote 17), paragraph 22; *van Hilten-van der Heijden* (cited above, footnote 29), paragraph 48; and *N* (cited above, footnote 5), paragraph 45.

31 — *Marks & Spencer* (cited above, footnote 2), paragraph 39. As regards allocation according to the worldwide income and source state principles, see the Opinion of Advocate General Geelhoed in Case C-374/04 *Test Claimants in Class IV of the ACT Group Litigation*, points 49 to 51.

32 — *Marks & Spencer* (cited above, footnote 2), paragraph 46.

54. The second element of justification recognised in *Marks & Spencer*, namely preventing the danger that losses are used twice, is closely connected to the allocation of the power to impose taxes.

55. The allocation of power to impose taxes on the basis of elements of territoriality (an undertaking's residence or source of income within the territory) serves to confer on a State a primary right to tax certain income. This, taken together with the rules to prevent double taxation, creates an international system of tax competence. In principle, and even if not without lacunae in particular cases, this system is intended to ensure that all income is taxed, and taxed only once.[33]

56. If it were possible for losses to be set off against profits more than once, some profits would not be taxed at all, notwithstanding that in fact there were no corresponding deductible losses. This would infringe the principle of once-only taxation, which is fundamental to the international allocation of the power to impose taxes.

57. Recognising cross-border intra-group transfers could also lead to double non-taxation of income if the transfers could be deducted from the taxable profits of the transferor company notwithstanding that they were not taxable in the country in which the recipient company had its seat.

58. According to the observations submitted by the United Kingdom Government, that might actually happen in the circumstances of the main proceedings. That is because under United Kingdom law intra-group transfers are not taxable income, and accordingly could not be taxed in the hands of the recipient company, AA Limited, although that is disputed by Oy AA.

59. Irrespective of the actual treatment of intra-group transfers to British companies, it should be held that a rule which generally provides that only intra-group transfers between Finnish companies are deductible for tax purposes is, in theory, apt to prevent losses from being used twice. This is because so far as purely internal transfers are concerned the Member State can ensure that the transfers are subject to tax. The further question remains to be considered as to whether the measure in this form goes no further than is necessary to achieve its purpose.[34]

33 — Once-only taxation can be achieved by two States acting with reference to one another, for example by the application of the imputation method.

34 — See below, point 67.

60. The risk of tax avoidance as the third element of justification is also closely linked to the other two elements of justification. One might regard intra-group transfers to companies resident in Member States in which such payments are not taxable in itself as tax avoidance. To that extent this justification may be considered together with the second justification.

61. Moreover, in *Marks & Spencer* the Court regarded as tax avoidance the 'escape' by undertakings to the State in which losses had their highest value and thus gave the largest reduction in tax liability, by transferring losses from low taxation to high taxation jurisdictions. It is likewise to be regarded as tax avoidance in this sense for income to be deliberately transferred, by means of intra-group transfers, to companies resident in low taxation jurisdictions.

62. Strictly speaking, prevention of this form of 'tax avoidance' is not a separate ground of justification which can justify a restriction on freedom of establishment. The fact that undertakings seek to profit from the differences between national tax systems is a legitimate form of economic conduct, and is indeed inevitable in an internal market in which taxation of corporations is not harmonised. Accordingly, an undertaking cannot simply be prevented from moving its seat to another Member State which offers more favourable conditions of taxation. [35]

63. Restrictions on the fundamental freedoms can be justified only if such 'tax optimisation' also undermines the allocation of powers to impose taxes between Member States.

64. Recognising the allocation of powers to impose taxes according to the principle of territoriality as a ground of justification is not inconsistent with the principle that restrictions on the fundamental freedoms cannot be justified by reference to the purpose of preventing a reduction in tax revenue. [36] This principle means simply that fundamental freedoms cannot be restricted on account of purely fiscal considerations. By contrast, the present case concerns the fundamental interest of granting the Member States a right at all to impose taxes according to the principle of territoriality.

65. In summary, it should be held that restricting the deductibility of intra-group transfers to transfers to Finnish companies is

35 — As regards the questions of taxation on migration arising in this context, see the recent judgment in *N* (cited above, footnote 5).

36 — *Manninen* (cited above, footnote 5), paragraph 49, and *Marks & Spencer* (cited above, footnote 2), paragraph 44.

apt to safeguard the allocation of powers to impose taxes between Member States, to exclude the possibility that income which is transferred is not taxed, and to combat tax avoidance. It ensures that profits earned by group companies in Finland are subject to taxation there according to the principle of territoriality.

66. There remains to be considered whether the provision does not go beyond what is necessary and proportionate (within the narrower meaning of that term) to achieve these purposes.

67. If the only issues were to ensure that transferred income was taxed and to prevent tax avoidance, the general restriction on deductibility of intra-group transfers to transfers to Finnish companies would go too far. Specifically, these two purposes could also be achieved by a rule which was less restrictive of freedom of establishment. As already explained, one might make the deductibility for tax purposes of an intra-group transfer conditional on proof that the income was in fact taxed in the hands of the recipient company.

68. However, safeguarding the allocation of powers to impose taxes, which is directly connected to the other two grounds of justification, could not be achieved by a corresponding, less restrictive national provision. A rule which required the State in which the transferor company was resident to allow a deduction provided that the transferee was taxed would not preclude a transfer of the power to impose taxes.

69. Weighing up the various interests, it also appears that a provision such as is laid down by the Finnish Law on Intra-group Financial Transfers is proportionate within the narrower meaning of that term.

70. In *Marks & Spencer*,[37] the Court regarded it as disproportionate not to recognise a cross-border transfer of losses in a particular, exceptional situation which arose in that case, namely where the non-resident subsidiary had exhausted all possibilities of utilising its losses and the losses could not be taken into account in the future either. In those circumstances the interest in safeguarding the allocation of powers to impose taxes was outweighed by freedom of establishment, and the transfer of losses to

37 — *Marks & Spencer* (cited above, footnote 2), paragraphs 53 to 56.

the non-resident parent company had to be allowed.

71. However, on the information the reference for a preliminary ruling gives as to the facts, it does not appear that Oy AA is in an exceptional situation corresponding to that in *Marks & Spencer*. It follows that there is no cause to consider whether, by way of exception, the principle of proportionality requires a divergence from the allocation of powers to impose taxes.

### C — *Free movement of capital*

72. The provisions on intra-group transfers could be assessed by reference to free movement of capital as guaranteed by Articles 56 and 58 EC, in parallel to freedom of establishment. However, apart from its territorial and temporal scope of application, which are not material in the present case, the same principles apply as apply in the context of freedom of establishment. It follows that restrictions on free movement of capital inherent in the provisions relating to intra-group transfers are likewise justified in order to safeguard the allocation of powers to impose taxes between Member States.

## V — Conclusion

73. On the basis of the foregoing considerations I suggest that the question from the Korkein hallinto-oikeus should be answered as follows:

In the circumstances described in the reference for a preliminary ruling, Articles 43 EC and 48 EC, Articles 56 EC and 58 EC, and Council Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States do not preclude a system such as that of the Finnish legislation on intra-group transfers in which a condition for the tax-deductibility of an intra-group transfer is that both the transferor and the transferee be companies resident in Finland.