COMMISSION OF THE EUROPEAN COMMUNITIES

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COMMUNICATION FROM THE COMMISSION TO THE COUNCIL, THE EUROPEAN PARLIAMENT AND THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE

Tax Treatment of Losses in Cross-Border Situations

{SEC(2006) 1690}

1. CROSS-BORDER LOSS RELIEF AND THE INTERNAL MARKET

1.1. Introduction

This Communication is presented within the framework of the Communication on "Co-ordinating Member States' direct tax systems in the Internal Market" and provides an example of an area which could benefit from such a co-ordinated approach.[1]

The Commission is committed to improving the competitiveness of business in the European Union, which is hampered among other things by the absence of cross-border relief for losses[2]. In its 2005 Communication "The contribution of taxation and customs policies to the Lisbon Strategy"[3], action to alleviate this problem was listed as one of the targeted measures which could be taken in the short term to remove cross-border tax barriers faced by EU firms. Such action is particularly timely in the light of the recent decision of the European Court of Justice (ECJ) in the *Marks & Spencer* case[4]. In the absence of cross-border relief for losses, the offset of losses is generally limited to the amount of profits generated in the Member States (MS) in which the investment is made. That distorts business decisions within the internal market.

This Communication[5] explains the basic principles and problems regarding cross-border loss relief. It suggests ways in which Member States may allow the cross-border relief of losses which are sustained either:

- **within one company** (i.e. losses incurred by a branch or "permanent establishment" of the company situated in another Member State); or
- **within a group of companies** (i.e. losses incurred by a group member in another Member State).

1.2. The Issue

Although companies expect to earn profits, they may incur losses. Virtually all tax systems within the EU treat profits and losses asymmetrically: profits are taxed for the tax year in which they are earned but the tax value of a loss is not refunded by the tax administration when the loss is incurred. It is thus necessary to set losses off against another positive tax base within the company or within the group of companies in order to avoid "overtaxation". That avoids cash-flow disadvantages resulting from the time lag in the taking into account of the loss, i.e. as a loss carry-forward and a set-off against future profits, in comparison with an immediate set-off against another positive tax base.[6] Cross-border loss relief would prevent losses becoming stranded in different entities.

1 COM(2006) 823 final.

2 COM(2001) 582 final, "Towards an Internal Market without tax obstacles", p. 12.

3 COM(2005) 532 final, p. 8.

4 Case C-446/03 *Marks & Spencer* [2005], not yet published.

5 The Commission staff working document SEC(2006)1690 contains technical annexes with further explanations and illustrations.

6 In Case C-397/98 *Metallgesellschaft* [2001] ECR I-1727 the ECJ already held that cash-flow disadvantages, as they arise in situations where there is no immediate relief for losses, are sufficient to conflict with EU law.

A company with several domestic branch operations will in principle be automatically taxed on the net result, i.e. both the profits and the losses of these branches will be automatically and immediately taken into account. In most other situations, relief for losses is possible only where authorised by a specific provision adopted by the respective Member States.

	Domestic relief of losses	**Cross-border relief of losses**
Within one company („permanent establishment")	Automatically available	Available in most cases
Within a group of companies („parent" and „subsidiary")	Available under specific rules in most MS	In principle **not** available, with very few exceptions

1.3. The Internal Market and Impact on Business Decisions

Different treatment of cross-border losses by Member States has an impact on the functioning of the internal market. Cross-border loss relief issues influence business decisions on whether and how to enter a new market. The lack (or limitation) of cross-border loss relief creates a barrier to entering other markets, which perpetuates the artificial segmentation of the internal market along national lines.

As a result, companies in large Member States, which are able to achieve greater economies of scope and scale within their own national market, have an advantage over potential competitors from smaller Member States, even where the latter are more innovative and efficient. Larger companies will normally have more activities in different Member States than smaller companies, which will ensure that larger companies can absorb losses more easily. Similarly, Member States with larger domestic markets have an advantage because it is more likely that companies already have investments in these markets, and thus are able to set any loss from particular activities against the positive tax base of others. The issue is of particular relevance to SMEs with respect to start-up losses arising from new investments abroad.[7] The lack or limited availability of cross-border loss relief therefore:

– favours domestic investments and acts as a disincentive to investments in other Member States;

– favours cross-border investment in larger Member States;

– favours large companies in comparison with SMEs when it comes to cross-border investments; and

– influences the choice between a permanent establishment and a subsidiary as a form of establishment.

These distortions lead to higher prices for both businesses and consumers and to a concomitant welfare loss. Where the limited availability of loss relief leads to less competition within the markets of a Member State the dominant companies will suffer in the long term because there is less intense pressure on them to innovate and become more efficient.

[7] The particular difficulties faced by SMEs in relation to cross-border economic activity (lack of cross-border loss relief and high compliance cost) are addressed in the Commission's Communication on a Home State Taxation Pilot Scheme (COM(2005) 702 final).

1.4. Cross-Border Loss Relief and the Case Law of the ECJ

The ECJ has dealt with cross-border loss offset involving **permanent establishments** in the *Futura*[8] and *AMID*[9] cases.

In *Futura*, the Court looked at the situation from the perspective of the **host State** of the permanent establishment, finding that the territoriality principle could justify limiting the amount of loss carry-forward available in that State to the losses that had an economic link with income earned there.

In *AMID*, adopting a **home State** perspective, the Court found that the exemption from taxation of Luxembourg permanent establishment profits under Belgium's double tax agreement (DTA) with that country did not establish, in respect of loss relief, an objective difference between the situation of a Belgian company with a permanent establishment in Luxembourg and that of a Belgian company with an establishment (branch) in Belgium.[10] In the absence of justification, different treatment of those two companies as regards the deduction of losses was contrary to the freedom of establishment and could not be accepted.[11]

The issue of cross-border loss relief **between companies** was the subject of an ECJ decision for the first time in the *Marks & Spencer* case. It was claimed that the refusal to allow the UK parent to set off against its profits the losses of its foreign EU subsidiaries which did not carry on business in the UK infringed the freedom of establishment provided for by the EC Treaty. Trading losses had eventually led to the complete cessation of the activities of most of the subsidiaries.

The UK put forward several justifications for this restriction: (a) the need for a balanced allocation of taxing powers between the Member States, (b) the need to prevent losses from being taking into account twice, and (c) the risk of tax avoidance. The ECJ accepted that these three factors, taken together, could justify provisions restricting the freedom of establishment[12]. However, it found that the UK group relief scheme did not respect the principle of proportionality where the possibilities for having the losses taken into account in the subsidiary's State of residence had been exhausted.

2. LOSSES WITHIN ONE COMPANY – THE ISSUE OF LOSSES INCURRED BY PERMANENT ESTABLISHMENTS

Losses within a company may be defined as losses incurred by dependent parts of a company, e.g. separate departments, branches or permanent establishments.

2.1. Tax Treatment of Losses in Domestic Situations

Relief for losses arising in domestic operations within a single company is automatically granted in all Member States ensuring that losses within the company are immediately taken into account. Since the company will be taxed on the net result of all domestic branch

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8 Case C-250/95 *Futura* [1997] I-2492.
9 Case C-141/99 *AMID* [2000] I-11621.
10 Case C-141/99 *AMID* [2000] I-11621, paras 28 and 29.
11 Ibid, paras 30 and 31.
12 Case C-446/03 *Marks & Spencer* [2005] para 51.

activities, the relief will be automatically recaptured where the loss-making part of the company returns to profit.

2.2. Tax Treatment of Losses in Cross-Border Situations

The company will usually be taxed, as a non-resident, on the results of the permanent establishment in the Member State in which the permanent establishment is situated. Under EC law, the permanent establishment must be granted the same treatment under national law as resident entities: for example, loss carry-forward or carry-back.[13]

The results of the permanent establishment then form part of the overall results of the company in the Member State of the head office. DTAs normally give the host Member State the primary taxing rights for the profits of the permanent establishment. The Member State of the head office will usually have only secondary taxing rights to those profits. The Member State choice of technique for eliminating double taxation depends on which of the two methods outlined in Art. 23 of the OECD Model Convention (the credit method or the exemption method) has been adopted in DTAs with other Member States.

a) Credit Method

The credit method takes worldwide income into account in the company's State of residence. Taxes paid abroad are credited against the part of the domestic tax levied on the income taxed abroad. The credit method therefore works in a similar way to the treatment of losses of domestic establishments. Any loss will be taken into account when determining worldwide income.

b) Exemption Method …

The exemption method generally excludes foreign income taxed in the source country from the tax base of the head office.

(1) … without loss deduction

Since results of a permanent establishment are not taken into account at the level of the head office, no loss relief is available. This approach is applied by seven Member States.

(2) … with (temporary) loss deduction

At present, five Member States provide for a deduction of losses sustained by permanent establishments situated in another Member State, although profits are exempted. These losses are recaptured once the permanent establishment returns to profitability (thereby ensuring tax cohesion).

2.3. Freedom of Establishment and Losses within one Company

Where losses incurred by permanent establishments may not be set off against profits of a head office ("vertical upward" set-off), there will be a difference in treatment in comparison with a purely domestic situation. This makes it less attractive to exercise freedom of establishment and a company may refrain from setting up a permanent establishment in

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[13] E.g. Case C-311/97 *Royal Bank of Scotland* [1999] ECR I-2651.

another Member State. Such a difference in treatment constitutes an obstacle to the freedom of establishment which is prohibited by Article 43 EC. The ECJ explicitly stated in *AMID* that the situation of a company with a permanent establishment abroad is in a comparable situation to that of a company without one.[14]

The need to prevent losses being taken into account twice may be addressed by a recapture mechanism. Whereas in domestic situations loss recapture occurs automatically, in cross-border situations such a recapture mechanism has to be provided for expressly. The fact that five Member States already do so shows that a system with loss deduction and recapture from future profits is feasible.

The risk of tax avoidance is very limited for the losses incurred by a permanent establishment, since losses are taken into account only at the level of the head office ("vertical upward" set-off).

3. LOSSES WITHIN A GROUP OF COMPANIES – THE ISSUE OF LOSSES INCURRED BY FOREIGN SUBSIDIARIES

3.1. The Rationale for Loss Relief within a Group of Companies

Companies which have legal personality under civil law are generally subject to corporate income tax in all Member States. The incorporation of an activity results in a separate entity, not only from a legal, but also from a tax point of view. A group of companies does not have legal personality under corporate law; nor is such a group recognised as a single taxable entity in its own right. Therefore, within a group of companies, losses are not taken into account automatically in the way they are within a company. However, from an economic point of view, a group of companies can be regarded as a single economic unit. Many Member States have introduced a domestic system for group taxation in order to treat a group as a single economic unit. However, only a limited, albeit increasing number of Member States have loss relief systems that also apply to cross-border situations.[15]

The lack of a domestic group taxation scheme distorts investment decisions mainly regarding the legal form of the investment (it favours the establishment of a branch rather than a subsidiary), but not decisions regarding the location of the investment. The lack of cross-border loss relief for groups of companies, however, can also distort business decisions as regards both the legal form and the location of investment.

3.2. Domestic Relief for Losses within a Group of Companies

Six Member States do not provide for a domestic system of group taxation. The schemes applied by the other nineteen Member States may be broadly classified in the following three categories:

(a) system of "intra-group loss transfer" (seven Member States);

(b) "pooling" of tax results of a group (eleven Member States); or

(c) full tax consolidation (one Member State).

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14 Case C-141/99 *AMID* [2000] I-11621, para 25 ff.

15 Denmark and France have applied such schemes for many years. Italy and Austria have introduced them as of 2004 and 2005.

The term "intra-group loss transfer" covers both "group relief" and the "intra-group contribution". Both these types of system allow a definitive transfer of income between companies in order to relieve losses against profits within a group. Under a "group relief" system a loss from one group member can be transferred (or "surrendered") to a profitable group member. Under an "intra-group contribution" system the profits from one group member can be transferred to a loss-making group member. To the extent that the "intra-group contribution" system is used to eliminate losses, it therefore has the same economic effect as a system of "intra-group loss transfer".

A "pooling" system involves aggregating all individual tax results (i.e. profits and losses) from the members of a group at the level of the parent company. This "pooling" is not necessarily linked to the existence of losses although this will be the main reason for applying such a system. "Full tax consolidation" goes beyond a pooling system, since for tax purposes the legal personality of the group members and any intra-group transactions are disregarded. The results of the group are determined on the basis of a single profit and loss account.

When applied domestically, all methods provide for full <u>vertical upward/downward</u> (i.e. between parent and subsidiary) and <u>horizontal</u> (i.e. between subsidiaries) loss compensation within a group. This means that if the group shows an overall net loss, the profits of individual members of the group will not be subjected to tax, but will be set off against the losses of other group members. All methods have the effect of providing immediate relief by preventing losses being stranded in different entities. Owing to automatic recapture, the relief is generally temporary, until the loss-making subsidiary becomes profitable again. The relief is permanent only where the losses are terminal.

Simply extending regimes applicable in domestic situations to cross-border situations, although representing an improvement over the current situation, would not produce an ideal solution. In domestic situations recapture of the losses is automatic: extending such a scheme to cross-border situations therefore needs an explicit mechanism for recapture. It could also be technically difficult to extend all aspects of a domestic system for loss relief to a cross-border situation. All Member States with a system for cross-border loss relief apply different rules in cross-border and domestic situations.

3.3. Defining the Scope of a Targeted Measure

3.3.1. Demarcation vis-à-vis a Common Consolidated Corporate Tax Base (CCCTB)

Any targeted measure to introduce cross-border loss relief represents an intermediate solution pending the adoption of a CCCTB. It would be easier to develop and implement but necessarily narrower in scope than an EU-wide CCCTB. It would not require any harmonisation of tax systems or the tax base. Unlike the CCCTB, which is based on a "multilateral" or "common" approach, a targeted measure could theoretically be designed only to require implementation and operation by one Member State ("unilaterally"). Nevertheless, coordinated action by the home country and the foreign investment country would be the most appropriate approach.

3.3.2. The implications of the judgment in Case C-446/03 Marks & Spencer

The following principles and guidelines may be deduced from the judgment: first, in order to protect a balanced allocation of taxing powers, the State of the parent company would only grant <u>permanent</u> loss relief in the case of <u>terminal</u> losses. Second, the need to prevent companies from taking losses into account twice can be addressed by making relief conditional upon the subsidiary having exhausted the immediate possibilities for loss relief available in its Member State of residence. Third, the risk of tax avoidance increases when a group of companies is free to determine when and where it wishes to have its losses (and profits) taken into account for tax purposes. This problem is greater the more choice a company has in offsetting its losses horizontally or vertically downwards. Companies would naturally tend to allocate the loss to companies where the tax value is the highest.

The Commission believes that these concerns can largely be met by limiting cross-border relief to vertical upward situations. Combined with a recapture provision and a requirement that any relief currently available to the subsidiary be used first, that would minimise the risk of tax avoidance.

3.3.3. Conceptual Framework – Guiding Principles for a Targeted Measure

A targeted measure addressing cross-border loss relief should ensure that corporate groups doing business in several Member States are treated as far as possible in the same way as groups doing business with a single Member State. In particular, it should allow losses to be set off from the tax base for the year in which they are incurred. A targeted measure should thus:

(a) permit an effective and immediate, once-only deduction of losses;

(b) allow, as a minimum, losses to be taken into account at the level of the parent company ("vertical upward" set-off);

(c) not normally result in a definite shift of income from one Member State to another, unless the losses are terminal and there is no possibility for relief in the State where such losses were incurred;

(d) exhaust domestic possibilities for current loss relief first; and

(e) not offer scope for abuse.

3.4. Alternatives for Cross-Border Loss Relief

In theory, there are three possible alternatives which provide for such a minimum level of loss compensation. These alternatives do not differ as regards the taking into account of the losses, but do differ with regard to their treatment of future profits of the subsidiary at the level of the parent company:

Tax year of loss	**Deduction of loss in the year of loss**		
Subsequent tax year(s)	**Alternative 1** definitive loss transfer future profits are not taken into account	**Alternative 2** temporary loss transfer recapture of deducted loss	**Alternative 3** current taxation of subsidiary's results taking into account of results of loss-making entity for a certain period

3.4.1. *Alternative 1: Definitive loss transfer ("intra-group loss transfer")*

This scheme would lead to a definitive transfer of losses (within a "group relief" scheme, as was the case in *Marks & Spencer*) or profits (within an "intra-group contribution" scheme) without recapture, unless counterbalancing measures were introduced. One way of neutralising the effect on the revenue of the Member State in which a loss-absorbing company is resident would be to introduce a clearing system so that the Member State of the company surrendering the loss would compensate the Member State of the company absorbing the loss. The system would need to take account of any significant differences between applicable tax rates and tax accounting rules. Special attention would also have to be given to tax planning issues.

3.4.2. *Alternative 2: Temporary loss transfer ("deduction/reintegration method")*

Under this scheme a loss incurred by a subsidiary situated in another Member State, which was deducted from the results of the parent company, is subsequently recaptured once the subsidiary returns to profitability. This results in a temporary transfer of losses. This was the approach chosen in the 1990 proposal for a Directive.[16]

The advantage of this method is that it is relatively easy to operate. First, the losses are deducted, and later, when the subsidiary returns to profit, the loss previously deducted is recaptured through a corresponding additional tax burden at the level of the parent company. This mechanism should therefore allow immediate, temporary relief at the level of the parent company, thereby avoiding the cash-flow disadvantages which would otherwise occur.

3.4.3. *Alternative 3: Current taxation of subsidiary's results ("system of consolidated profits")*

Under this system, the profits and losses for a given tax year of selected or all group members are taken into account over a certain time period at the level of the parent company. Consolidated subsidiaries would be treated in the same manner as permanent establishments. The credit method would be applied to eliminate double taxation. Tax paid by a subsidiary in its State of residence would be credited against the tax payable in the Member State of the parent company in respect of income from the subsidiary. Profit distributions between the group members would not be taken into account.

The application of such a scheme is not linked or limited to the existence of losses (although this will be the main reason for its application). Therefore, once a subsidiary has been elected to participate in such a scheme, it will normally be applied for a certain period, e.g. 3, 5 or more years.

A system of consolidated profits may be designed to comprise either:

– one or more subsidiaries selected at the taxpayer's discretion – a **selective scheme**, or

– all subsidiaries of a group – a **comprehensive scheme**.

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16 COM(90) 595 final. Proposal withdrawn OJ C 5, 9.1.2004, p. 20.

Of the two schemes, a selective scheme would require less documentation but could be vulnerable to aggressive tax planning techniques involving concentrating cost in subsidiaries chosen for consolidation. Under the comprehensive scheme the overall financial position of the group will be subject to taxation in the State of residence of the parent company. The credit method will help eliminate opportunities for tax arbitration based on the calculation of the tax base and tax rates. The main disadvantage would be an increased compliance cost due to the need to recalculate the income of all group members under the rules of the parent company's Member State.[17]

4. CONCLUSION

The Commission stresses the need for effective systems to provide cross-border loss relief within the EU. The limited availability of cross-border loss relief is one of the most significant obstacles to cross-border business activity and an effective internal market. Introducing systems for cross-border loss relief will particularly benefit SMEs, which currently suffer from the lack of such relief. It will also remove a major impediment to the emergence of more competitive EU firms on the world market.

Losses within a company

Where Member States do not allow losses incurred by permanent establishments in other Member State to be taken into account, the Commission strongly encourages these Member States to review their tax systems in order to promote the freedom of establishment provided for by the EC Treaty.

Losses within a group of companies

The Commission encourages Member States to introduce and maintain domestic tax systems for loss relief within a group of companies that offer treatment equivalent to that provided for loss relief within a single company. This would eliminate distortions and enhance the attractiveness of the country in question as an investment location and thereby help to meet the objectives of the Lisbon Strategy.

The Commission stresses the need to make cross-border loss relief within a group of companies more widely available, for the development of businesses across the single market and worldwide.

This Communication presents three possible approaches for offering cross-border loss relief. The response should be coordinated in order to maximise the benefits for the internal market and reduce unnecessary duplication of effort in the 25 Member States.

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17 For SME-groups, the Home State Taxation could solve the major disadvantages.

The Commission invites the Council, the European Parliament and the European Economic and Social Committee to examine the proposals set out in this Communication with a view to urging Member States to:

- review existing national systems in order to provide relief for losses within a company in cross-border situations;
- rapidly implement one or more of the possible solutions presented in this Communication for the treatment of losses incurred within groups of companies; and
- consider how the suggestions in this Communication can be applied to both domestic and cross-border situations by improving existing loss relief schemes and by introducing new ones.
