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Where Does Foreign Loss Utilization Go in Europe?

WOHIN GEHT DIE STEUERLICHE VERLUSTVERWERTUNG IN EUROPA?

Fragen der steuerlichen Verlustverwertung bestimmen zur Zeit die Diskussion im Europäischen Steuerrecht. Claus *Staringer* analysiert die dazu ergangene Rechtsprechung des EuGH und versucht die Perspektiven der weiteren Rechtsentwicklung in diesem Bereich zu zeigen.

I. Overview

The organizers of this conference have thankfully invited me to speak here on „foreign loss utilization" in my capacity as an academic rather than as a lawyer. Taking an academic perspective at cross-border loss utilization seems to be a challenging task, since this is obviously a topic at the core of practical tax planning. So I will be brave trying to tell you about what the law actually is on cross-border use of losses in the European Union. This is indeed challenging, as this is presumably the most discussed topic in European tax law these days.

I will talk about *Marks & Spencer* first, of course. But only in brief, because I am sure that you will have already heard everything that you ever wanted to know about this case – and probably even more than that. To avoid duplications, I will therefore try to put emphasis on the perspectives that can be taken from *Marks & Spencer* for the future.

In the second part of my speech, I will take a closer look at the analysis of *Marks & Spencer* and other recent cases, asking the question that currently is on top of European tax lawyers' minds: Is *Marks & Spencer* a turning point in European tax law? This should clearly not be a theoretical exercise, since it can be translated into a rather practical question: What can businesses still expect from the EC freedoms in the field of cross-border use of losses after the *Marks & Spencer* decision – or is there anything at all that you can expect?

Finally, at the end of this speech, I will turn to a vision of how corporate taxation, including the use of cross-border losses, could be further developed within Europe according to the plans of the European Commission.

II. *Marks & Spencer* – What is the Actual Outcome?

I am brief on the facts of the case, as you will certainly know them: The UK parent of the *Marks & Spencer* group wanted to apply the UK group relief system to three continental European loss making subsidiaries (in France, Germany and Belgium), arguing that UK legislation was in breach of EC freedoms in denying the group relief for losses of foreign EU subsidiaries. Given the huge potential fiscal consequences that may have arisen from a *Marks & Spencer* win in the proceedings, the *Marks & Spencer* case was very closely followed by the tax community. General expectation was that *Marks & Spencer* would be a "landmark decision", a "major breakthrough", or even the „millennium case".

The actual outcome of the case before the ECJ is now well known – and it is rather limited.[1]) The ECJ denied that there is a general obligation in the Treaty of Rome that

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[1]) ECJ 13. 12. 2005, C-446/03, *Marks & Spencer.*

the UK would have to allow a deduction for foreign subsidiaries' losses under its group relief system. Such obligation exists, according to the ECJ, only in exceptional cases where it is secured that the foreign sub may not take use of its losses itself in its residence state. Insofar, there is not more than an "ultimate responsibility" of the parent's Member State to allow for foreign loss deduction.

Many commentators felt that the *Marks & Spencer* ruling was disappointing and complained that the ECJ, rather than "breaking through", has made a „step back" from European integration in the field of direct taxation.[2]) Given the high expectations in the case, this will not be wrong. However, interestingly, most business representatives were rather relieved than disappointed from the ruling. This is because prudent businessmen/women had realized that, if *Marks & Spencer* had come through with the claim in general, national legislators of the Member States would have felt serious pressure to abolish their group taxation systems in total, since they would have seen no other way to avoid a discriminatory effect of these systems that typically recognize domestic losses only. This results in what is often mentioned as the „*Marks & Spencer* paradox"[3]): In limiting *Marks & Spencer's* claims to an exceptional case, the ECJ may at the same time have actually saved the benefits that many taxpayers enjoy under the Member States' current group taxation systems.

This paradox throws some light on what the *Marks & Spencer* case was really about: It was not a case on creating a new framework for the use of foreign losses in Europe, but simply a case on the scope of a pre-existing national group taxation system in the European market. This is an important difference. Current European law is not able to create such thing like "European foreign loss utilization" in its own right. All that European law can do, if at all, is to widen the scope of existing national group taxation rules. If there are no such domestic rules, European law will, by its nature, fail to generate foreign loss deduction.

But now back to the *Marks & Spencer* ruling. There are already libraries full of commentaries on the case and its outcome. I am not going to repeat these commentaries here, but I will try to focus on the key aspect of the ruling: The crucial issue of the ruling is the fact that it is rather difficult to say when there is the required „exceptional situation" where Member States are under the obligation to accept the deduction of foreign losses. Obviously, it is this difficult issue that businesses will be most interested in.

Such „exceptional case" is described in the ruling as *„where the subsidiary has exhausted the possibilities available in its residence state to make use of the losses, either by the subsidiary itself or by a third party, in particular where the subsidiary has been sold to that third party"*.[4]) This gives rise to a number of questions. I will talk about some of them.

First, what are the „possibilities available" mentioned by the ECJ? Is the mere legal existence of a loss carry-forward instrument in the subsidiary's Member State such a "possibility", regardless of the likelihood that losses will be effectively used against future profits (i. e. if the subsidiary is a permanent loss maker)? In such case, does the parent have to wait until the subsidiary is finally legally dissolved in order to have its losses transferred to the parent? This seems to be, at least from the business perspective, a rather "legalistic" or even strange view. Nevertheless, current general

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[2]) See *Lang*, The *Marks & Spencer* Case – The Open Issues Following the ECJ's Final Word, European Taxation 2006, 54; *Wathelet*, *Marks & Spencer plc vs Halsey*: Lessons to be drawn, British Tax Review 2006, 131.

[3]) *Smit*, *Marks & Spencer*: The Paradoxes, European Taxation 2006, 411.

[4]) ECJ 13. 12. 2005, C-446/03, *Marks & Spencer*, no. 55.

perception of the *Marks & Spencer* ruling is leaning towards this approach, although, not surprisingly, there were also some doubts raised in this point.[5])

Second, what if there is a „possibility available" like a loss carry-forward instrument in the subsidiary's Member State's legal order, but its requirements for a loss carry-forward are no longer given for the subsidiary, e. g. if it no longer runs an active business (given that many Member States apply an active business test for loss carry-forwards)? Notably, in the *Marks & Spencer* fact pattern, two of the three foreign subsidiaries of *Marks & Spencer* had actually discontinued their trading business. Therefore, the need will arise (as it has already arisen in the continued *Marks & Spencer* proceedings) to evaluate national rules in the subsidiary's state on the limitation or denial of loss carry-forwards, e. g. in case of a business discontinuity.

Third, what if a taxpayer has, in his subjective view, exhausted all „possibilities available" – is he now under the burden of proof that it is not subjectively but objectively impossible to make any use of the losses? Reading the *Marks & Spencer* ruling, one may be inclined to reach such conclusion. But how to prove a negative here? This may be rather difficult in practice. Should one ask the tax authorities for their clearance? Or is there a requirement to consult outside experts in the subsidiary's state for confirmation that even the finest tax planning would not save the losses, so all „possibilities available" have been exhausted?

In addition to all the above, there are even more difficult questions: How to make sure that losses are not used by a third party, in particular a buyer of the subsidiary? How should the former owner get the necessary information from the buyer? And if there should be such information available, is it sufficient to rely on it *bona fide*? Or is there a duty of investigation whether the information is wrong and there actually is a use of the losses by the new owner? Finally, the timing aspect: Does the seller have to wait until the new owner finally dissolves the subsidiary, possibly after many years? How about procedural obstacles for such long-term concepts like statutes of limitation?

All in all, it will be fair to say that *Marks & Spencer* has given some answers. But it has also opened a number of new questions that will have to be clarified in the future in order to make the *Marks & Spencer* doctrine work in practice.

III. Is *Marks & Spencer* a Turning Point in the ECJ's Case Law?

I am now turning to the second part of my speech. This will deal with the more general question whether the *Marks & Spencer* case is a turning point in the ECJ's case law on direct taxes.[6])

The key question here is what the impact of *Marks & Spencer* on other loss utilization cases may be. *Marks & Spencer* dealt with only one specific scenario under one national system, therefore covering only part of the entire spectrum of cross-border use of losses. There are other cases on their way or even already pending before the ECJ, like *REWE Zentralfinanz* (on the deduction of write-offs of foreign shareholdings)[7]) or *Oy AA* (on the Finnish group contribution system).[8]) Further, the court will also have to deal with cases on foreign permanent establishment (PE) loss deduction, where a double tax treaty provides for the exemption method.[9])

[5]) See the concerns raised by *Marks & Spencer PLC* in the continued UK proceedings before the High Court of Justice [2006] EWHC 811 (Ch).

[6]) See also in general *Vanistendael*, The ECJ at the Crossroads: Balancing Tax Sovereignity against the Imperatives of the Single Market, European Taxation 2006, 413; *Lang*, Direct Taxation: Is the ECJ Heading in a New Direction? European Taxation 2006, 421.

[7]) Opinion of AG *Poiares Maduro*, 31. 5. 2006, C-347/04, *REWE Zentralfinanz*.

[8]) Opinion of AG *Kokott*, 12. 9. 2006, C-231/05, *Oy AA*.

[9]) See the recent requests for preliminary ruling of the German Federal Supreme Tax Court, 28. 6. 2006, I R 84/04, 22. 8. 2006, I R 116/04.

This wider spectrum of cross-border loss cases makes it worth looking at the underlying doctrine that the ECJ has applied in *Marks & Spencer*. Such analysis could be of value, since the initial hypothesis is that the ECJ will try to apply its doctrine again – courts typically prefer following existing routes to exploring new ones. I will therefore try to demonstrate elements of this doctrine in applying them on three issues that are not, at least not finally, decided: (i) the deduction of foreign PE losses under an exemption treaty, (ii) the issue of a double use of losses, and (iii) the court's theory what „tax avoidance“ is.

1. Foreign PE Loss Deduction

For losses incurred by a foreign PE, the European issue is whether in spite of the existence of a tax treaty with the PE state that provides for „exemption“ for foreign PE losses, such losses should nevertheless be deductible on grounds of EC freedoms. The argument would be that there clearly would be such deduction for losses of a domestic PE, so the cross-border case is discriminated. Unfortunately, the ECJ has missed an excellent opportunity to clarify this issue in the *Ritter-Coulais* case where exactly this issue was brought forward by the submitting national court, but the ECJ has refused to deal with it for procedural reasons.[10])

What could be the principles applied to such case, if brought to the ECJ in the future? In *Marks & Spencer*, the ECJ has developed a key argument called the *"balanced allocation of taxing powers"*. The court there says that European law should follow the well-established principle of international tax law that there should be a balanced allocation of taxing powers between States. The ECJ says that it is accepted in international tax law that states should, at least in general, have no taxing power over a foreign subsidiary's profits. Therefore, Member States may in turn legitimately restrict the deduction of foreign subsidiary's losses. In *Marks & Spencer*, this "balance" argument has led the court to the conclusion that it is not against EC law if a parent's Member State symmetrically excludes foreign subsidiaries' profits and losses from its tax jurisdiction, even if the subsidiary is resident in another Member State. Transferred to the PE case, this would mean that there is a similar "balance", as the treaty precludes the headquarters' state from taxing foreign PE's profits and losses symmetrically.

In its core, the "balance" argument in *Marks & Spencer* is based on the assumption that there actually exists such principle of "balanced taxing powers" in international tax law as regards foreign subsidiaries. However, this principle may be debatable. It is doubtful whether such principle equally exists for profits and losses of foreign permanent establishments. There are several reasons for such doubts: First, there are some European Member States that actually interpret their tax treaties in such way that the treaty exemption for a foreign PE exempts only the PE's profits, but does not exclude the PE's losses from deduction in the headquarters' state (subject to recapture).[11]) Second, it is to be noted that even the OECD model commentary is open on this issue and advises the Contracting States to clarify it in the respective treaty by explicit provision.[12]) Third, there are many countries (including EU Member States) that allow or have allowed in the past for a foreign PE loss deduction in their national laws in spite of the existence of a treaty exemption. These countries effectively overrule the treaty exemption for losses by their national laws.[13]) It seems therefore that, unlike in the

[10]) ECJ 21. 2. 2006, C-152/03, *Ritter-Coulais*. See also *Meussen*, The *Ritter-Coulais* Case – A Wrong Decision in Principle by the ECJ, European Taxation 2006, 335.

[11]) For Austria see Sec. 2 para. 8 of the Income Tax Act following the Supreme Court decision VwGH 25. 9. 2001, 99/14/0217; for Luxembourg see the decision of the Cour Administrative 10. 8. 2005, No. 19.407C, see also *Winandy*, New Case Law Developments: Tax Treatment of a Losses of a Foreign Permanent Establishment, European Taxation 2006, 82.

[12]) OECD Commentary to the Model Convention Art. 23A No. 44.

[13]) E.g. Germany in the former Sec. 2a of the German Income Tax Act.

subsidiary case, there is no such clear "balance" or "symmetry" principle in international tax law for the PE case.

In the light of this, it might well be doubted whether the ECJ's key argument may actually work in a PE case, i. e. that there is a generally agreed principle in international tax law that foreign PE losses, symmetric to PE profits, should not be taxable in the headquarters' state. Of course, in the absence of a clear picture in international tax law, the court might then search for such a principle directly in European law. However, this appears even more doubtful as there is no clear indication in the Treaty of Rome or existing case law that European tax law, in itself, may include such a general principle of balanced or symmetric taxing powers. Accordingly, it will be difficult for the court to apply its key argument from the *Marks & Spencer* case to a PE case as well.

2. Double Use of Losses

If foreign losses are deducted, there is a certain natural risk for a double use of losses. The question now is, whether such double use is, in itself, an effect that is contrary to European law and may therefore be legitimately restricted by the Member States. This is a question that goes far beyond the question of group taxation, as the same issue may arise for virtually every case where a double dip deduction of losses is at stake.

In *Marks & Spencer*, the ECJ explicitly referred to this issue. The court argued that Member States may legitimately take measures against such double use of losses. At first sight, this appears convincing. However, taking a closer look, it is surprising since, in a non- harmonized tax system like the EU, it is rather natural that there could be a double deduction of expenses or losses. Equally, there could be a double taxation of income in two Member States. This is simply the effect of the absence of harmonization measures in direct taxation in the EU. If this effect should lead to economic distortions, Member States may be under political pressure to coordinate their systems. But from a legal perspective, such distortion is not more than an effect of current law, and if one wished to avoid this effect one would have to change the law. This was exactly the ECJ's approach over years, leading to the court's role as the „engine of harmonization" in direct taxes. Apparently, this approach seems to be under change now. *Marks & Spencer* was a first shot into a new direction.

A few weeks ago, Advocate General *Kokott* made a second shot in her opinion in the *Oy AA* case.[14]) In *Oy AA*, the Finnish group contribution system is at issue. In the case, a Finnish resident profitable subsidiary made a group contribution payment to its loss-making UK resident (indirect) parent. Under Finnish law, such payment would be deductible for the subsidiary if made to a domestic parent, while payments to a foreign parent are not deductible (even if resident in the EU). The implicit logics of the Finnish system are that a deduction for the sub is acceptable if the receipt is in turn taxable for the parent. This was not the case for *Oy AA's* UK parent, so there is a risk of double non-taxation of *Oy AA's* contributed profits (I leave aside the issue whether it would make a difference if the parent were taxable, but not in Finland but in the UK).

To avoid such double non-taxation, AG *Kokott* now argues that there is an "international competence system" in place that distributes the power to tax income amongst states. On the basis of the assumed existence of such a system, AG *Kokott* then concludes that there is a general principle that a certain item of income should be taxed once (and non-taxation is to be avoided). If losses were now used twice, this would necessarily lead to a non-taxation of income as there would be an extra offset of income with losses. Therefore, it should be generally justified if the Finnish system does not allow for a deduction of cross-border group contribution payments.

[14]) Opinion of AG *Kokott*, 12. 9. 2006, C-231/05, *Oy AA*.

This is not the place to finally judge on this theory. But the obvious issue with such a view is that there is no basis for such rather fundamentally assumed principles in the Treaty of Rome. To the contrary, as community law now stands, there seem to be better arguments that there is no such commonly recognized principle of avoiding double deductions in Europe, given the clear absence of any tax harmonization measures.

3. Tax Avoidance

My last point is on tax avoidance. In *Marks & Spencer*, the ECJ has cleared the UK legislation also as a measure against tax avoidance: If taxpayers were free to transfer losses from low tax to high tax Member States, this would entail the risk of tax avoidance, against which Member States may take appropriate measures.[15])

This raises several questions: Can it be that businesses which benefit in their tax planning from the diversity of tax rates in the EU are in „tax avoidance“ and that this status may, per se, trigger countermeasures? Isn't it a natural consequence of the absence of tax harmonization in the EU that businesses are free to organize themselves in the most tax-efficient way, including making losses effective where there is best use of them?

There is also an interesting connection to the *Cadbury Schweppes* case.[16]) In *Cadbury Schweppes*, the ECJ has (again) characterized „tax avoidance“ structures as „wholly artificial arrangements“. Importantly, for such wholly artificial arrangements, the court has applied rather low (if not only minimum) substance thresholds, so it may well be expected that practice will be able to live with this concept of tax avoidance.

Now, how can it be that in a *Cadbury Schweppes* setup (using a low taxed Irish financial services company with minimum business substance) there is no „tax avoidance“ risk, while in *Marks & Spencer* a foreign loss relief for truly active businesses is considered „tax avoidance“? This result is even more questionable, bearing in mind that a cross-border loss use aims at no more than being taxed fairly on consolidated profits rather than being over-taxed on profits in one country and isolated from losses in another country.

It seems that the ECJ is still struggling to find a truly comprehensive tax avoidance doctrine. But there will be a next chance: AG *Kokott* has realized in her opinion in the *Oy AA* case that the *Marks & Spencer* tax avoidance doctrine has gone too far. But although she confirms that trying to establish a cross-border group taxation in general is not tax avoidance, she believes that there is such tax avoidance where the Member States' tax systems are "undermined".[17]) It is obvious that this is far from being clear. We can only hope that the ECJ will be able to tell us what this concept of "undermining" means.

IV. The Vision – CCCTB

Finally, coming to the end of my speech, I fear that I gave you more questions than answers on the topic. But now to the vision that I promised at the beginning.

Over the last two years the European Commission has made significant efforts to promote the concept of a common consolidated corporate tax base (CCCTB). Such a system provides not only for a common set of European rules determining the tax base, but is also designed to work on a consolidated basis. Taxpayers (or groups of taxpayers) that are under the CCCTB regime would therefore calculate only one tax base, setting off all income and losses, irrespective of their national origin, in the CCCTB area. Such a consolidated tax base would then be apportioned under a "magic" formula (which has

[15]) ECJ 13. 12. 2005, C-446/03, *Marks & Spencer*, No. 50.
[16]) ECJ 12. 9. 2006, C-196/04, *Cadbury Schweppes*.
[17]) Opinion of AG *Kokott*, 12. 9. 2006, C-231/05, *Oy AA*, No. 63.

yet to be found) to the various Member States involved which may tax their profit portion under domestic tax rates.

One can see that this project of the Commission is far-reaching and even brave, with a view also to the announced delivery date for a legislative proposal of the Commission as soon as 2008. Time will tell us how this project progresses. But at least there would be one benefit in the CCCTB regime: As there would be an implicit recognition of a cross-border use of losses in the consolidation mechanism, all the issues I was talking about would no longer exist – at least in the Commission's view. Let's see whether the future will be so kind to us.

Abstandnahme von der Abzugsbesteuerung bei gewinnlosen Orchestervereinen

(BMF) – Durch Pkt. 3.1 c des BMF-Erlasses vom 31. 10. 2005, AÖFV. Nr. 256/2005, sollte keine steuerliche Begünstigung, sondern lediglich eine Verwaltungsvereinfachung herbeigeführt werden; es sollte dann, wenn mit ausreichender Sicherheit erkennbar ist, dass im Rahmen von Nachfolgeveranlagungen gem. § 102 Abs. 1 Z. 3 EStG die gesamte Abzugssteuer wieder rückzuerstatten ist, der Steuerabzug von vornherein unterbleiben. Der Erlass zeigt auf, unter welchen Bedingungen der Veranstalter diese Voraussetzung als gegeben annehmen kann.

In EAS 1501 wurde für Gastspiele ausländischer Orchester ein Textvorschlag für eine Erklärung vorgesehen, der auf der Grundlage des zitierten Erlasses folgenden Wortlaut haben könnte (wobei noch die Veranstaltungsdaten und die Bezeichnung und Anschrift der Trägerkörperschaft des Orchesters angegeben werden müssten):

Ich/wir erklären als vertretungsbefugte Organe des xxxx Orchesters:

1. *Dem in Österreich gastierenden Orchester gehören xx Mitglieder an.*
2. *Jedes einzelne Mitglied des Orchesters erhält für die Mitwirkung an der/den obgenannten Veranstaltung/en Vergütungen, die neben den steuerlich abzugsfähigen Kostenersätzen den Betrag von 440 Euro pro Veranstaltungstag bzw. 900 Euro für mehrere Veranstaltungstage nicht übersteigen (eine Liste über die jedem Orchestermitglied gezahlten Vergütungen und die bei ihm abzugsfähigen Aufwendungen liegt als BEILAGE 1 bei).*
3. *Jedes Orchestermitglied hat durch eigenhändige Unterschrift bestätigt, dass in diesem Kalenderjahr in Österreich keine Einkünfte erzielt werden, die den Betrag von 2.000 Euro überschreiten, und dass es andernfalls eine diesbezügliche Meldung an den österreichischen Veranstalter abgibt, der in der Folge hierüber das zuständige österreichische Finanzamt informieren wird (siehe BEILAGE 1).*
4. *Das Orchester selbst erzielt aus der/den obgenannten Veranstaltung/en kein körperschaftsteuerpflichtiges Einkommen in Österreich (die Höhe der aus der/den obgenannten Veranstaltung/en erzielten Einnahmen und die damit verbundenen abzugsfähigen Aufwendungen sind aus der BEILAGE 2 ersichtlich).*
5. *Name und Anschrift aller Orchestermitglieder sowie ihre Reisepassnummern sind in BEILAGE 1 erfasst.*

Bei der Beurteilung, welche Betriebsausgaben den aus dem inländischen Konzert erzielten Betriebseinnahmen zuzuordnen sind, sind nicht nur die direkt zuordenbaren lokalen Kosten anzusetzen, sondern es können auch aliquote Teile der Produktionskosten geltend gemacht werden (EAS 2511 betreffend ein österreichisches Theater mit Auslandsauftritten), wobei aber darauf zu achten ist, dass diese indirekten Kosten aliquot aufgeteilt werden. In EAS 2511 wurde eine aliquote Aufteilung nach einem Umsatzschlüssel als gerechtfertigt angesehen. *(EAS 2788 v. 20. 11. 2006)*