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Opinion Statement of the CFE ECJ Taskforce on losses compensation within the EU

for individuals and companies carrying out their activities

through permanent establishments

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This is an Opinion Statement on losses compensation within the EU, prepared by the ECJ Taskforce[1] of the Confédération Fiscale Européenne (CFE). The CFE is the leading European association of 32 national tax advisory organisations representing over 180,000 tax advisers.

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1. Generalities on the international tax background

Loss compensation is closely linked to the structure of the tax system, be it as regards the taxation of individuals, partnerships or companies. Generally speaking, a loss can be defined as an excess of expenses over receipts when, similarly, profits represent an excess of receipts over expenses, the question being to define both "receipts" and "expenses". In constructing their tax systems, States can opt for global or schedular taxation of income. In the latter case, the question is raised of the compensation of losses incurred in one schedule against income in other schedules. The way to determine the loss depends on each country's provisions resulting from tax policy and technical choices.

Traditionally, profits are defined by reference to periods of time – generally of one year -, so that another important point is the offsetting losses from one to another period. Carry-over of losses is generally viewed as an exception to the annual nature of the income tax assessment; in that conception, unlimited carry-over of losses at first sight appears to be a kind of gift from the tax authorities to the taxpayers. This conception however does not correspond to economic reality: when considering the income accrued to an individual, the period to be considered should be his/her lifetime. Similarly, income generated by an enterprise should be viewed over the duration of its activities. If one supposes a profit of 100 in Year N and a loss of 100 in Year N+1, with no carry-over of losses, the taxpayer would pay taxes on 100 while its economic income over the period would be zero. This type of

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situation cannot be supported under economic life. Note that the State raises revenue on economically non-existent income.

Thus, economic efficiency and equity plead in favor of unlimited in time carry-over of losses; however, convincing arguments exist for limiting the carry-back period.

Similar situations occur with cross-border scenarios. This paper will focus mainly on the situation of individuals and companies carrying out international activities through permanent establishments[2].

Under internationally accepted tax practice, tax jurisdiction is usually based on a difference between residents and non-residents. It is recognised that the State of residence is allowed to tax the worldwide income of its residents – but it could choose to limit its jurisdiction to territorial income -, while the State of source can only tax income having its source in its territory.

The combination of both tax jurisdictions leads to potential international double taxation. Where a loss appears in one of the two States, the question is raised whether such loss may or must be set-off against profits taxable in the other State. Here again, usually, the State of Source does not take into consideration losses incurred outside its territory. The State of source will usually allow for carry-over of losses from other tax periods (be it carry-back and/or carry-forward, limited or unlimited). Thus, the State of source does not have to take into consideration losses incurred by its non-residents in another country, be it in their State of residence or another State from which they accrue taxable income.

As regards the State of Residence, worldwide taxation of income – if applied – leads to immediate and automatic off-setting of losses. Strict territorial taxation[3], on the contrary, prohibits taking into account losses incurred abroad. Thus, territoriality appears as economically inefficient from the point of view of the loss-making enterprises: at best, the

[2] Similar problems are also faced by groups of companies. However, even if most solutions can be transposed to such context, problems arising within a group must be dealt with by taking into consideration the proper characteristics of their functioning and are therefore not analysed in this paper.

[3] What international tax practice understands under this term is taxing only the income generated within the territory. It is worth remembering that the ECJ has developed different meanings of this term.

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enterprise has to anticipate the tax payment up to the moment the loss is carried-over in its country of origin; if, on the contrary, the loss is never compensated, the total tax burden for the enterprise exceeds the amount of tax that it would have born in a purely national context.

Worldwide taxation combined with carry-over of losses in the State of Source leads to "apparent" double compensation of losses, but we use the term "apparent" because this double deduction is automatically eliminated through subsequent taxation of foreign income by the State of residence[4].

2. Loss compensation under ECJ case-law

At that stage, it is necessary to comment on a phrase used by the ECJ in some of its case-law on loss compensation: according to the Court, for a tax system to allow for loss compensation of foreign permanent establishments in order to determine the taxable results constitutes a "tax advantage/*avantage fiscal*".[5] This is not, in our view, fully correct. Loss compensation is inherent in a worldwide taxation regime, and any restriction of cross-border loss-compensation is contrary to such a regime. Such loss compensation allows for similar treatment of residents having cross-border activities and residents having internal activities at the moment where the loss is incurred.

2.1. Identification of the restriction

This characterisation as a "tax advantage", which the Court raised in *Marks & Spencer*, can be agreed on only when considering groups of companies[6] and loss compensation between parent and subsidiary companies. A difference exists indeed between single legal entities

[4] Suppose a profit of 100 in the State of Residence and a loss of 100 in the State of Source in Year N: the taxable income for year N in the State of Residence amounts to zero, due to the loss compensation. For Year N+1, the profit amounts to 100 in both States: the taxable income amounts to 200 in the State of Residence. Globally, the State of Residence taxes 200, which is the economic income realised by the taxpayer on its territory; the State of Source taxes 0 (-100 + 100), which is the result of the activity in its territory. The total tax basis for the taxpayer corresponds to its real economic income.

[5] *M & S*, at para. 38; *Lidl Belgium*, at para. 23.

[6] On group taxation, see IFA Congress 2004, *Cah. IFA*, 2004, Vol. A.

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having foreign permanent establishments and subject to worldwide taxation in their State of residence, on the one hand, and companies being legally independent which are, for each of them, subject to taxation on their profits in their State of residence. The view that cross-border loss-compensation represents a "tax advantage"[7] can be agreed with only as regards group structures.

2.2. Impact on loss compensation of the methods of avoiding double taxation

Coming back to losses in relation to permanent establishments, complexity increases when the State of Residence applies one of the methods of exemption or tax credit in order to eliminate international double taxation of income.

There are two accepted views regarding the exemption method. Under the first one, exemption implies exclusion from the tax base in the State of Residence of both the foreign profits and losses. Under the second one, only the foreign profits are to be excluded from the tax base in the State of Residence, while the foreign losses will be set-off as a consequence of the application of worldwide taxation; the latter is also in line with the well-recognised view according to which a double tax treaty must not render the situation of the taxpayer worse[8]. The OECD Model Convention, together with its Commentary, is not decisive on this point[9], and leaves the choice to the Contracting States[10].

It must be pointed out that total exclusion of foreign results leads to worsening the situation of transnational enterprises with foreign losses. This is a restriction when one considers the structure of worldwide taxation on the one side, and the aim of international tax treaties – eliminating double taxation – on the other side.

[7] "Tax advantage" is not a technical term.
[8] See for example, Administrative Court of Appeal of Luxembourg, 10 August 2005. Austrian Supreme Administrative Court, 25 September 2001.
[9] See on this point, German Bundesfinanzhof, 12 March 1980, (1980) BStBl, II, 531; BFHE 296 and 12 January 1981, (1981) BStBl, II, 517, discussed in European Taxation, 1981, 357.
[10] See § 23/44 of the OECD Commentary to the OECD Model-Convention.

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On this point, State practice varies. Belgium, Spain[11], the Netherlands[12], Austria[13], Luxembourg[14], for example, allow the deduction of foreign losses while exempting foreign income from permanent establishments. Germany construes exemption as excluding any foreign result – be it positive or negative – from the tax base of its residents. The ECJ seems to follow this last view, as proved by the *Lidl Belgium* decision, where the Court considered that a permanent establishment is an "autonomous entity" according to international legal practice, and that granting loss compensation is a "tax advantage", followed by the statement that "*the provisions of the [considered] tax regime do not grant such a tax advantage where the losses are incurred by a permanent establishment situated in a Member State other than that in which the principal company is established*"[15].

Excluding the foreign result (positive or negative) from the tax base in the State of residence under exemption has similar consequences as those of a territorial system: foreign losses cannot be set-off against profits taxable in the State of residence.

2.3. Justification

Before the ECJ, it has been argued that there is a risk of double compensation of the foreign loss if it is set off in the State of residence, as the loss will normally be carried over in the State of Source[16]. The need to prevent such double compensation is recognised by the ECJ as a valid element of justification of the restriction.

It should be recalled first of all that apparent double loss compensation is inherent in a worldwide taxation system and results from the "allocation of the taxing power" between the States of residence and source according to internationally recognised practice. Under such

[11] Art. 22 of the Spanish Corporate Income Tax Law.
[12] Article 35 of the Besluit voorkoming dubbele belasting 2001.
[13] See §2(8)Z,3 EStG (Austrian ITC): losses that cannot effectively be offset against taxable income in the country where the permanent establishment is situated can be deducted from taxable income in Austria; to the extent the foreign country allows a loss carry-forward a recapture rule applies when the permanent establishment turns profitable."
[14] Cf. fn 7.
[15] ECJ, 15 May 2008, Case C-414/06, at 26 and 39. See also *Krankenheim*, at para. 32 and para. 35 (ECJ,23 October 2008, C-157/07).
[16] *M & S*; *Lidl Belgium*.

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a regime, however, the risk of true double tax relief is automatically eliminated through taxation of foreign income in the State of residence when it is earned.
States which relieve international double taxation by means of exemption of foreign income may achieve the same result by means of a recapture mechanism in the State of residence, under which subsequent foreign income is taxed up to the amount of the loss.
Accordingly, the risk of double compensation can normally be excluded by a less restrictive measure than refusal to grant relief for foreign losses.

We can conclude, at this stage, regarding permanent establishments, that worldwide taxation has as a direct consequence cross-border loss-compensation. Countries which do not recognise this in fact apply territoriality rather than worldwide taxation. Considering subsidiaries, we would conclude that their treatment is based on territoriality, so that any cross-border compensation is viewed as an exception, a "tax advantage".

As regards the EU, the fundamental question would be whether territoriality applied to cross-border losses is in accordance with the idea of an internal market. Of course, in a cross-border situation, economic efficiency for the enterprise opposes the State's interest to protect the raising of revenue: why should a State allow for a reduction of its tax base by loss-offsetting while this State does not tax foreign income? There is a balance to be reached.

2.4 Is there a right under EU-law to off-set cross-border losses?

In its *Marks & Spencer* decision – dealing with intra-group losses – the Court held that there must be an off-setting of foreign losses in the State of residence of the parent company when there is no more possibility of compensation in the foreign State (i.e. the State of residence of the subsidiary[17]). Implicitly, this means that there is a right to cross-border loss compensation, and possibly this right would be based on economic reality and efficiency.

[17] *Marks & Spencer* at para.55.

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Similarly, in the *Amid* and the *Mertens* cases, the Court recognised the right to the benefit of an effective compensation: the cases concerned Belgian tax residents who, according to Belgian rules, had their losses incurred in their Belgian activities set-off against profits from their foreign permanent establishments which were to be exempted according to a double tax convention. The compensation of the Belgian loss against foreign exempt income was an obstacle to the carry-over of the loss on future Belgian profits, leading to an economic double taxation. While the Belgian Government argued that "*the disadvantage suffered by Mr Mertens is the result only of the inevitable differences between the various Member States' national legislation and the exercise of the tax powers by their authorities"*, the Court replied that *"those arguments, based on national law and the Convention, do not show that the national legislation at issue in the main proceedings is pursuing a legitimate objective compatible with the Treaty or that application of that legislation does not go beyond what is necessary to achieve that objective*"[18].

On that view, the conclusion of the ECJ in *Lidl Belgium* cannot be endorsed[19] and it is questionable whether this decision does not lead to territoriality which, we believe, is contrary to the idea of an internal market. In *Lidl*, which concerned losses from a foreign permanent establishment, the Court decided that "*article 43 EC does not preclude a situation in which a company established in a Member State cannot deduct from its tax base losses relating to a permanent establishment belonging to it and situated in another Member State, to the extent that, by virtue of a double taxation convention, the income of that establishment is taxed in the latter Member State where those losses can be taken into account in the taxation of the income of that permanent establishment in future accounting periods*".

The ECJ may have refined this statement in *Krankenheim*, where the coherence of the tax system was used to admit the possibility for the State of Residence to "recapture" the foreign losses whenever future income becomes available in the State of Source and such country allows for the set-off of prior year losses. Compensation in the State of Residence thus appears as a residual means of compensation, priority being on the State of Source, in any

[18] *Mertens*, para. 39.
[19] See the ECJ Task Force Opinion on *Lidl Belgium*, *European Taxation*, 2008/11, pp. 590-596.

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situation where income exists in that country allowing for the compensation. This interpretation is in line with the *Marks & Spencer* statement where the Court ruled on the obligation for the State of Residence to grant compensation when there is no further possibility for setting-off losses in the State of Source. It must be noted that this conclusion may lead to tax competition between the Member States when elaborating their loss compensation rules.

If one accepts the idea of loss-compensation, then the question is raised when to proceed to the compensation. From the *Marks & Spencer* case, it can be concluded that off-setting must be granted in the State of residence when it is proved that no compensation is possible any more in the State of source. On this point, we have three comments.

First, it puts transnational enterprises incurring foreign losses at a cash-flow disadvantage. On the other side, the State of residence raises its revenue, while the loss will impact the revenue in the State of source later on when carried-over. If the loss can be carried-over at one moment in time, this finally results in a "timing difference". However, when the loss cannot be set-off, the enterprise will finally support an excessive tax burden considering its real economic income; this is not economically efficient. As regards States, there is also a kind of timing difference. Economic efficiency would plead for an immediate set-off which might allow the enterprise to survive, and States to continue raising revenue from it on a long term basis.

Secondly, based on the idea recognised by the Court in *Amid*, that residents having international activities should be treated in a same way as resident having internal activities only, off-setting of foreign losses in the State of residence should occur at the moment when the loss appears; so, immediate compensation should be the rule. Double loss compensation can be avoided through adequate recapture rules combined with exchange of information.

Third, this statement of the Court in *Marks & Spencer*, which it repeats in some way in *Lidl Belgium*, already leads to a kind of tax competition as between Member States. Those

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Member States which can afford (or take the risk) to grant immediate relief for foreign losses will be in a tax advantageous position.

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