Treatment of Cross Border Losses in the European Union

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“… a common market entails the elimination of all obstacles to intra-Community trade in order to merge the national markets into a single market bringing about conditions as close as possible to those of a genuine internal market”

*Case 15/81, Gaston Schul, 1982*
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Abstract

Taxation within the European Union continues to be an aspect of national sovereignty for which Member States are unwilling to relinquish control. Within the field of direct taxation, the lack of mechanisms available to offset cross border losses is one of the major obstacles to the completion of the internal market. The need for cross border loss relief becomes more and more apparent as Member States increase their level of involvement with each other. This leads to the paradox that there is meant to be one market yet there remains a plurality of tax systems.

This paper combines an analysis of various countries’ group taxation systems, with the current methods employed by Member States for the elimination of double taxation, in order to illustrate the differences and similarities between them, provide reasoning behind the lack of coordination, and determine their compatibility with the potential implementation of measures which would allow cross border loss relief throughout the European Union.

Case law related to cross border losses will also be discussed and examined in order to demonstrate how the Court of Justice (CJ) has played a leading role in advancing progress within the field of direct taxation through negative integration. The paper will furthermore explore the possible options for future cooperation and the likelihood of moving towards a convergence of the Member State’s tax systems.
List of Terminology

AG - Advocate General
CCCTB - Common Consolidated Corporate Tax Base
CJ –Court of Justice¹
EEA - European Economic Area
EU – European Union
HRMC - Her Majesty’s Revenue and Customs
HST – Home State Taxation
MS – Member State
M&S – Marks & Spencer case
PE – Permanent Establishment
SME - Small and Medium Sized Enterprises
TFEU - Treaty on the Functioning of the European Union
The Court – Court of Justice
UK – United Kingdom

¹ As per Amendments to the Treaty on European Union and to the Treaty Establishing the European Community C 3-6/10 Article 9 para 1. 17 December 2007
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1. Introduction

Over the past sixty years, the European Union (EU) has been an impressive success. On a previously war torn continent, it has buried the worst prejudiced nationalism of the past without destroying patriotism. Its institutions have become recognized for binding dispute settlements that has enabled the transformation of sovereignty through common decisions on an unparalleled number of sensitive areas. “It is a union of nation states that has created something less than a federation yet more than an alliance” (Patten 2010).

In the year 2000, the EU set out to turn itself into the world’s most competitive, knowledge-based economy by 2010 through the Lisbon Treaty. The necessity for such change lay in the falling growth rate and the need to compete in high tech industries, while the goals were to consolidate powers and streamline bureaucracy (The New York Times 2010). This has proven to be a challenge, especially due to the recent financial crisis which shook the EU. But Europe prevailed and the Lisbon Treaty has now been ratified by all Members. The recent crisis demonstrated just how interdependent Member States’ economies are, and the fact that there are currently 27 different tax systems to deal with; along with a large degree of variation in corporate tax rates (see Annex 1) indicates continued high levels of restriction for the internal market. The road to recovery is still a long one, and the necessity for restructuring is apparent. Taxation is high on the list of issues needing to be addressed, and the national systems need to support the objectives laid down in the Treaty.

The purpose of the European Union is to create an area free of barriers to goods, services, people and capital; in essence forming a system that is comparable to the domestic market of a Member State. Yet when a company wishes to establish itself in another Member State, it is most often the case that losses made by this company, whether it be a subsidiary or in some cases a permanent establishment\(^2\), are unable to be offset against profits made by another member of the group. Most Member States in the EU allow automatic aggregation of national profits and losses, therefore taking into account the losses made in that Member State. As soon as the losses occur outside the border of a country, this is no longer the case.

\(^2\) A fixed place of business through which the business of an enterprise is wholly or partly carried on.
This results in a disadvantage to companies who expand into another Member State, as they are then unable to use the potential losses against profits, and many times they must still pay tax in the Member State making profit while the losses are sitting unused in another (Terra and Wattel 2008). The present co-existence of 27 different and sometimes even mutually incompatible corporate tax systems in the EU de facto imposes supplementary compliance costs and offers few opportunities for cross-border loss compensation. This should not happen in a truly single market. While in their commercial activities (research, production, inventories, sales, etc.) companies increasingly tend to treat the EU as one single market, they are obliged for tax purposes alone to segment it into national markets\(^3\).

European Union tax law related to direct taxation has often been defined as non-existent, as there are no laws in the Treaty to govern the Member States in this field. The only possibility to take action at the European level is through Art 115 TFEU (ex. Art 94 EC) which allows for the creation of Directives by a unanimous vote. To date, this has been used to generate five Directives\(^4\) which can be seen as solid progress considering the fact that unanimity is very difficult to achieve.

Each Member State’s tax law is composed of its own national tax law, the tax treaties that it has entered into and various aspects of EU tax law in the form of Directives, Resolutions and Codes of Conduct. Each of these separate parts are highly interactive and at the same time, often in conflict with one another (Helminen 2009).

Although there is no express reference to direct taxation in the Treaty, the primacy of EU law is evident through case law, as the Court of Justice (CJ) has defined the obligation to exercise fiscal competence consistently with EU Law\(^5\) in order to avoid any direct or indirect discrimination on the grounds of nationality\(^6\). For this reason, cases in which there is a conflict between national law and EU Law will result in the national law being amended to comply with EU law regardless of the importance of national sovereignty. The

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\(^3\) Communication from the Commission to the Council and the European Parliament - The Contribution of Taxation and Customs Policies to the Lisbon Strategy. COM/2005/0532 final

\(^4\) Directive 77/779 EEC; 90/434 and 435 EEC; and 2003/48 and 49 EC

\(^5\) ECJ, 12 May 1998, *Gilly* C-336/96

CJ has played a decisive and increasing role in direct tax matters, taking an activist stand, in view of achieving the integration that has not been possible by way of legislation. Negative integration\(^7\) has been the primary way forward in this area. The interpretation of the Treaty by the CJ has been the foundation for the removal of cross border taxation obstacles. Until the 1980’s there were no cases in this field; however, since that time, the number of cases has increased significantly (see Figure 1) which points towards the fact that direct taxation is quickly becoming a leading topic. The problem remains in the inconsistent nature of these initiatives and the rulings continue to result in grey areas that undermine the overall success of market integration.

It is necessary for Member States to take account of transnational situations when applying their tax rules and to adapt those rules accordingly.\(^8\) This raises further questions as to which one of the two States involved is accountable for the adjustment and as to which kind of adjustment is required (exemption, matching tax credit, arbitration, etc.). Does this obligation not amount to positive tax integration - effectively overstepping the boundaries of the judiciary by imposing constraints in an area which is reserved for the competence of Member States (Hinnekens 2006)?

As might be expected within this large number of cases, many controversial topics have arisen, one of which is the treatment of cross border losses. Cross border loss relief remains one of the main impediments to the free movement of establishment within the Single Market, indicating that a co-ordinated action on taxation at an EU level is necessary in order to provide national policy-makers support in tackling some of their biggest challenges and creating a more economically efficient union.

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\(^7\) The abolition of domestic law provisions and practices that constitute discrimination or a restriction in conflict with the EU Treaty or with EU Law through judgments from the European Court of Justice.

\(^8\) Opinion of the Advocate General, Poiares Maduro, delivered on 7 April 2005. Case C-446/03 Marks & Spencer plc v David Halsey (HM Inspector of Taxes)
1.1 Problem statement

Since the inception of the European Union, certain topics have been highly sensitive in regards to national sovereignty. National taxation is of high importance to each country, therefore any attempt to make changes at the European level, especially relating to the field of direct taxation⁹, has continuously been met with strong resistance. The paradox is evident as there is meant to be “one market” yet there remains a plurality of tax systems. The purpose of this paper is to examine the treatment of cross border losses by Member States in the EU as one of the major obstacles to the completion of the internal market. Through analysis of the different tax systems used in various Member States and other mechanisms applied in the tax regimes, I wish to determine whether a co-ordinated system for taxation would succeed within the current national systems of the Member States.

Although fiscal sovereignty is deemed necessary, it cannot be interpreted to mean ‘fiscal autarchy’ (Hinnekens 2006). When Member States signed on to the Treaty they agreed to submit to the regime of freedom of movement of goods, persons, services and capital

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⁹ EU Tax policy can be divided into two fields, indirect and direct taxation. The focus of this paper will be on direct taxation.
within the Community which in turn gives rise to specific constraints. The EU currently maintains a single currency (in most Member States) within a single market; making the necessity for consolidation across the countries within the union a very important part of an efficient tax structure. The lack of political support that has been seen in previous years has left ample space for the Court of Justice.

As politicians within the Member States have not been actively promoting tax solutions for the EU, the CJ has played a very important role in improving the business climate in Europe and in influencing the corporate tax structure. Discriminatory laws are being removed one by one, but the piecemeal approach creates tension and new distortions. It will therefore take quite some time before the CJ can impose changes on countries to such an extent that overall economic efficiency is improved. It would, of course, be better if countries took a more proactive stance instead of only reacting to the issues raised by the Court.

One of the main problems is that the CJ, in its decisions in the field of taxation, does not take into account how the outcome in each case will fit within the whole of the tax structure. Although it is up to Member States to design their own tax systems; the Court, by applying the Treaty, is moving beyond the purely nationalistic views often taken by Member States in their tax policies.

In order to discuss the difficulties and complexities in this field, a background of EU Tax Law, as well as developments that have occurred through case law from the Court of Justice will be presented. This paper will further analyze the different group relief systems currently in place in four Member States: Austria, Denmark, the Netherlands and the United Kingdom, in order to illustrate the differences between systems and the reasoning behind the lack of coordination. It will then further delve into the potential for future cooperation and possible movements towards a convergence of the Member State's tax systems.
1.2 Delimitations

This paper will focus solely on the corporate aspects of taxation within the European Union. Corporate tax policy consists of two components: direct and indirect taxation. Direct taxation remains the sole responsibility of Member States and continues to be a focus of discussion within the European Union due to its lack of coordination. Indirect taxation on the other hand, has made significant progress towards harmonization, especially through the recent VAT Directive\textsuperscript{10}. Cross border loss relief as the topic of this paper lies within the field of direct taxation; indirect taxation will not be discussed. Larger companies within the EU will also be the primary focus while small and medium sized enterprises (SMEs) will only be touched upon briefly.

1.2 Literary Review

As it is a topic of much debate and discussion, numerous papers and journals have been written relating to the topic of cross border losses within the EU. The overriding opinion throughout the various articles is that there is a strong necessity for the introduction of an instrument to combat the imbalance, yet it is also evident that the Member States may never agree unanimously on this topic. There are also those of the opinion that the deduction of foreign losses implies a loss in tax revenue for the loss absorbing state as well as the exploitation of tax differentials within the EU through the exportation of losses into higher tax jurisdiction, thus reducing the tax burden on income produced in the territory (Pistone 2003).

There are a few books which focus solely on the broader topic, which are: European Tax Law by Terra and Wattel (2005 and 2008) and EU Tax Law – Direct Taxation by Helminen (2009). These books provide a comprehensive overview of the basic principles and concepts of EC tax law which naturally includes a discussion on cross border loss relief.

The research related to country’s taxation systems was collected via national finance bureaus as well as national legal offices and global tax consultancies such as KPMG. The International Bureau of Fiscal Documentation (IBFD) is one of the most recognized sources

for taxation material in the world, and much of my research has been gathered through their publications. The analysis in this paper is also based on current EU legislation and publications which can be obtained at http://europa.eu.int/eur-lex.

1.3 Objectives

This paper will bring together case analysis with information on specific country legal systems and double taxation relief methods, in order to illustrate the differences and similarities between them and determine the effect that the implementation of cross border loss relief would have on these various systems. The need for cross border loss relief becomes more and more apparent as Member States increase the level of involvement with each other. Cases involving cross border loss relief will be discussed in order to demonstrate the importance of the efforts of the CJ towards harmonization of direct taxation. This importance has grown as the likelihood of achieving such coordination through Directives adopted into national law diminishes. The Court, in a number of cases, has taken positions on the conformity or non-conformity of national income and corporation tax laws with the basic freedoms contained in the EC Treaty, and will most likely continue in this trend unless further coordinated actions are taken.

In the field of indirect taxation, Member States have been more willing to renounce their sovereignty s they saw the importance and benefits of a harmonized system within the single market. This will inevitably occur for direct taxation, yet the way forward remains uncertain and will entail a long period of adjustment.

1.4 Methodology

My research draws on all sources of EU law including primary and secondary source law. Specific case law from the Court of Justice will be analyzed and the evolution of the legal framework surrounding cross border losses will be discussed. I will also conduct a critical analysis on four EU Member States’ group relief systems in order to determine their compatibility with EU tax law and how well suited they are for the potential implementation of a cross border loss relief instrument in the short term and the Common Consolidated Corporate Tax Base as a long term strategy. Various methods of double taxation relief will also be discussed including the exemption method and the credit method
in order to illustrate how compatible these would be if the above mentioned strategies are put into action.

1.5 Composition

Chapter 2 provides an overview of cross border losses as a sub-category of European taxation including the usability and the problems that arise from the lack of mechanisms in place to allow cross border transfers.

Chapter 3 outlines the history within the EU of cross border losses and shows that regardless of the fact that the topic has been on the agenda for many years, little progress has been made.

Chapter 4 introduces loss relief from the point of view of group taxation, including possible measures for a targeted solution and a longer term strategy. Three potential targeted solutions from the European Commission relating to cross border loss relief are discussed and analyzed.

In Chapter 5, four Member States’ national tax systems will be examined, compared and analyzed. The domestic and cross border loss relief of each country will be reviewed in order to determine its compatibility with EU standards. Their different systems of group relief will also be reviewed.

Chapter 6 discusses the methods for eliminating double taxation and how they relate to EU law on cross border loss relief. The compatibility of each system with the single market will also be considered.

It is essential when discussing a topic such as tax law to review various case law. This will be carried out in Chapter 7, beginning with a foundation of the 2005 landmark case *Marks & Spencer*. The cases reviewed will on one hand, indicate how negative integration has shaped European tax law into what it is today, and how the CJ has taken the leading role in shaping tax policies in the EU; yet will also point out the lack of coordination between national systems and the fact that case law does not provide clear guidelines which can be
followed.

Chapter 8 will look further into the future; exploring potential options going forward in the field of European tax law. These include targeted measures, options given by the Commission, implementing various systems that are already being used by Member States, as well as the highly discussed option of the Common Consolidated Corporate Tax Base (CCCTB) that would create one tax base throughout the EU.

2. Cross Border Losses

Losses in a permanent establishment (PE) or a subsidiary can be used in the Member State which they are resident against their own profits in previous years (available in some Member States) or in future years (available in nearly all Member States). When a non-resident subsidiary or PE incurs losses in a given year and the rest of the group has profits, the issue of offsetting cross border losses arises. Although the possibility remains to maintain the losses to be set against potential profits made in the future, there is still the cash-flow disadvantage and interest loss that makes loss relief in the current tax year a preferred option (Terra and Wattel 2005).

Nearly all tax systems in the European Union treat profits and losses inequitably as profits are taxed in the year which they are earned while the value of a loss is not refunded when it is incurred\(^{11}\). This creates the necessity for losses to be set off against profits in the year which they occur. This happens automatically for domestic groups of companies in most Member States\(^ {12}\), yet a cross border solution is only available in a limited number of Member States\(^ {13}\).

Within the internal market it should not be possible for losses to never be compensated at any level, whether it is at the subsidiary or parent level. In the preamble of the Parent

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\(^{12}\) Only 9 out of the 27 Member States do not provide any form of domestic group relief/consolidation. See Annex VIII in the Technical Annex of the Communication SEC(2006) 1690

\(^{13}\) Denmark, France, Italy and Austria
Subsidiary Directive it is stated that “it may be necessary to create within the Community conditions analogous to those of an internal market...in order thus to ensure the establishment and effective functioning of the common market...”\textsuperscript{14}, therefore, as within a domestic market where losses are deducted once, the same should apply within the internal market (van den Hurk 2006).

The absence of cross-border loss relief constitutes a barrier to entering foreign markets, therefore favouring establishment in large Member States due to the fact that without channels of cross-border loss relief, firms will try to ensure that their profits are taxed in countries where the size of the home market is sufficient to generate enough profit to offset possible losses abroad. The problem is especially relevant for small and medium sized enterprises (SME’s) as their home market is not large enough to cover the losses incurred, in particular, those incurred at start-up\textsuperscript{15}. It also distorts decisions regarding the legal form that an expansion will take, as a permanent establishment (branch) will take precedence over a subsidiary due to the fact that cross border relief of permanent establishments is permitted in many Member States.

The issue of competitiveness on a global scale is also particularly relevant. If a European group of companies has to pay corporate income tax in one of its EU subsidiaries in a particular year, even though the consolidated fiscal result of the group is zero or negative, the competitiveness of this group, compared to groups in the same position in the USA, China, India or Japan, will be weakened (Dorsey & Whitney LLP 2006).

### 3. History of Cross Border Loss Relief in the EU

Since the beginning of the European Union, direct taxation has been on the Commissions' agenda. The Neumark report of 1962 was the first report to state that the differences in tax bases and structures had the effect of creating a general state of confusion which required a

\textsuperscript{14} 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

\textsuperscript{15} European Parliament resolution of 15 January 2008 on Tax Treatment of Losses in Cross-Border Situations (2007/2144(INI)}
high degree of analysis and eventual harmonization (Chetcuti 2001).

The Commission wrote two memorandums in the 1960's both of which advocated full harmonization. Neither one was taken up by the Council, and in 1975 the Commission tried again with an action programme that stressed the importance of the achievement of economic and monetary union which then led to a draft Directive for the Harmonization of the Systems of Company Taxation and of Withholding Taxes on Dividends16.

In the 1980’s the Commission realized through continued failures that "any attempt to resolve the problem by way of harmonization would probably be doomed to failure"17. One of the primary reasons was the necessity for unanimity from all Member States regarding this topic, along with numerous other reasons including national tax sovereignty and political differences. In 1990, the 1975 proposal was withdrawn as the Commission stated that it no longer met the needs of a more fully integrated market. They instead devoted their efforts to more specific topics, and the “Guidelines for Company Taxation” paved the way for two Directives and one convention which were adopted later that year18.

The Committee of Independent Experts on Company Taxation (the Ruding Committee) was set up the following year, and the Ruding Report of 1992 identified that action was necessary at the Community level in order to significantly reduce the distortions that were affecting the operation of the internal market. The suggestions included a minimum corporation tax rate and common rules for a minimum tax base (Ruding 1992). The Commission guidelines which were a result of the Ruding report agreed with many of the propositions from the Ruding Committee including those relating to two already drafted Directives on the carry-over of losses (COM(84)404) and on losses of subsidiaries situated in other Member States (COM(90)595), the topic of which is still pending. (European Parliament 2000)

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17 "Report on the Scope for Convergence of Tax Systems" COM(80)139
18 The Mergers Directive (90/434/EEC), covering the treatment of capital gains arising when companies merge; The Parent Subsidiary Directive (90/435/EEC), eliminating double taxation of dividends paid by a subsidiary in one Member State to a parent company in another; and the Arbitration Convention (90/436/EEC), which introduced procedures for settling disputes concerning the profits of associated companies in different Member States.
The Commission took a new approach to taxation in 1996 primarily due to the creation of the Single Market and the completion of Economic and Monetary Union. The document, *Taxation in the European Union*, re-emphasized the reduction of the discriminatory treatment of subsidiaries established in other Member States, and indicated that the proposal which would allow parent companies to offset losses of subsidiaries was also still very much on the Commission’s agenda.\(^1\)

The Directive proposal in 1990 “Concerning arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States” was withdrawn in 2001 after the Commission wrote the communication “Towards an Internal Market without tax obstacles”. This report focused in more detail on the issue of direct taxation of companies in the European Union and one of the highlighted features was that of cross border loss relief. The Commission suggested a two-track strategy in which targeted measures would be a short to medium plan and a comprehensive solution through the consolidated tax base in the long term. The only targeted proposal relating to cross border loss relief was the possibility of adopting the Danish joint taxation system\(^2\) which will be discussed at a later point in this paper. It was also mentioned that a replacement of the proposal for a Directive on the topic was necessary after technical discussions and analysis had taken place.\(^3\)

Two further Communications came from the Commission in 2003 and 2005, both of which stated that the lack of coordination in the area of cross border loss relief constituted a fundamental obstacle to the Single Market, although little was said on potential remedies.


\(^3\) ibid

Finally in 2006, a focused Communication titled “Tax Treatment of Losses in Cross-Border Situations”\textsuperscript{23} was written.

In 2008, The European Parliament responded with a Resolution\textsuperscript{24} which urged the Commission to further investigate the possibilities of providing companies with a consolidated corporate tax base for their EU-wide activities, and stated that they welcomed the three options proposed in the communication (discussed in Chapter 4). The Parliament signalled its support for targeted measures which would enable the effective and immediate deduction of losses by foreign subsidiaries (on an annual and not simply terminal basis, as in the \textit{Marks & Spencer} case) which would then be recaptured once the subsidiary returns to profit through a corresponding additional tax on the parent company. This suggestion has appeared in the opinion of the Advocate General (\textit{Lidl Belgium}) yet was not taken up by the CJ in their decisions. This is due to the fact that the role of the CJ is to interpret the Treaty law, not to enforce it by instructing Member States how to act. Although this is the defined character of the CJ, the fact that there is no direction provided for the Member States regarding how to implement the rulings creates further confusion and lack of coordination. As each MS could implement the ruling differently, there continues to be a lack of harmony and limited progression.

\textbf{4. Group Taxation and Loss Relief}

Group taxation is designed to reduce the effect that the separate existence of related companies has on the aggregate tax liability of the group (Jones Day 2003). The rules involved in group taxation are further complicated by the fact that members of a group are treated as a single entity for many purposes, but as separate entities for other purposes, as well as by numerous anti-avoidance rules that are in place to prevent inconsistent combinations that the government believes to be inappropriate.


\textsuperscript{24} European Parliament resolution of 15 January 2008 on Tax Treatment of Losses in Cross-Border Situations (2007/2144(INI))
The move towards a common tax base is being explored by the European Commission as they recognize the need for such consolidation\(^{25}\) in order to tackle cross border loss relief, as well as other difficulties including transfer pricing and high compliance costs.\(^{26}\) The Common Consolidated Corporate Tax Base (CCCTB) was chosen by the Commission as the preferred way forward in this area. This is considered the long term strategy in the taxation policy of the EU, whereas targeted measures to combat cross border loss relief are a first step. The differences between the two are that the CCCTB is a harmonized action creating one common base for the entire EU while a targeted measure for cross border losses could be implemented unilaterally, as some Member States have already done (see Chapter 5). In order to proceed, the definition of a group within the EU is a priority, along with determining the necessary mechanisms and structural elements involved.

Most believe the CCCTB will never become reality, although that has been the opinion of many for issues in the past, including the adoption of the Euro. At this point in time, it does seem nearly impossible that all Member States will agree to such a system, but it remains apparent that some form of intervention regarding taxation at a higher level is necessary in order to fulfil the objectives of the internal market. Perhaps a system that targets specific aspects of the problem will be better accepted by the Member States, and cross border loss relief would be a good starting point for such action.

4.1 Possible options 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.”\(^{27}\)

\(^{25}\) Consolidation in this case implies that one single tax base is determined for a group of entities and even though tax would be charged at the level of each entity it would be on the share of the consolidated base calculated in accordance with the ‘sharing’ method, rather than the current individual income calculated on the arm’s length basis.


\(^{26}\) European Commission. 5 May 2006. Common Consolidated Corporate Tax Base (CCCTB WG). Issues related to group taxation. Working Document .CCCTB\WP\035\doc\en

Finding a measure to coordinate cross border loss relief will remove a major impediment to the emergence of more competitive EU firms on the world market. In the Commissions’ communication “Tax Treatment of Losses in Cross-Border Situations” of 2006, three possible alternatives to compensate for losses were suggested (see Table 1).

The first alternative is definitive loss transfer, also known as intra-group loss transfer. As the name implies, this refers to a definitive loss (or profit) transfer without recapture (as seen in the *Marks & Spencer* case). The losses from one Member State would therefore be relieved within the same tax year in another Member State. This would be similar to the current group relief regime in the UK.

**Table 1 – Commission Alternatives for Loss Compensation**

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<thead>
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<th>Alternative 1</th>
<th>Alternative 2</th>
<th>Alternative 3</th>
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<tbody>
<tr>
<td>Definitive loss transfer</td>
<td>Temporary loss transfer</td>
<td>Current taxation of subsidiary’s results</td>
</tr>
<tr>
<td>Future profits are not taken into account</td>
<td>Recapture of deducted loss</td>
<td>Taking into account of results of loss-making entity for a certain period</td>
</tr>
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</table>

Source: Commission communication on Tax Treatment of Losses in Cross-Border Situations 2006

The second option is temporary loss transfer, also known as the deduction/reintegration method. The losses are once again transferred from one MS to another, but the difference is that the losses are further recaptured when the loss-making company returns to profit. This creates the temporary nature of the mechanism. This is the method currently used in Austria, whose tax reforms of 2005 were seen as very progressive and in line with EU standards.

The third and final alternative is that of current taxation of the subsidiary's results or, system of consolidated profits. In effect, this would create a situation where a subsidiary is
treated as though it was a branch, and the net profits and losses of the group would be consolidated and taxed at the parent level. This would most likely need to have a minimum participation period, and it would have to be decided if it would apply selectively to chosen subsidiaries, or be comprehensive, forcing the inclusion of all subsidiaries. The system of consolidation is currently in place in the Netherlands through their fiscal unity regime, although as the recent X Holding case pointed out, the ability to include a non-resident subsidiary is still not accepted, and further work would need to be done in order for the Dutch system to fall completely in line with this alternative.

In the European Parliament’s Resolution28 of 2008, they favoured the second option of temporary loss transfer. Although the first option was the outcome from the CJ in the Marks & Spencer case, there are still many downfalls, including the possibility for aggressive tax planning, the possibility of claiming losses twice, and the loss of tax revenue for the loss absorbing Member State. It would also create a complex compensation regime which as the Commission states “would need to take account of any significant differences between applicable tax rates and tax accounting rules”.

The second option is easier to manage, and resolves the cash-flow disadvantages that could otherwise occur. The recapture mechanism was suggested by the Advocate General in the Lidl Belgium case29 yet was not mentioned by the CJ in their ruling, as it is not in their authority to tell the Member States how to implement decisions.

The third option is currently being used by the Netherlands, and is discussed further in Chapter 5 of this paper. Although the credit method can be used to avoid tax arbitration in this system, there are high compliance costs involved with the need to recalculate the income of the group under the rules of the parent company’s Member State30.

There are currently some Member States that allow cross border consolidation, and therefore loss relief. Today, Italy, Austria, Denmark and France allow for cross border consolidation: Italy and Austria under new rules, France under its longstanding option for

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29 Case C-414/06 Lidl Belgium GmbH & Co. KG. 15 May 2008
worldwide taxation and Denmark under its recently amended system of cross border consolidation (Dorsey & Whiteny LLP 2006). Although the mechanism is in place, the statistics on the use remains quite low. In France only 13 companies (data from 2006) have opted for cross border consolidation, while in Italy there is nearly no one applying for cross border consolidation (Dorsey & Whitney LLP 2006). According to the Danish Tax Ministry Statistics from 2005, the Danish cross border consolidation rules have also proven unpopular with only 211 Danish parent companies jointly taxed with a total of 343 foreign subsidiaries. This is most likely due to the fact that these systems are “all in or all out” and have long minimum lock-in periods. The inflexibility of these systems may yet prove to be contrary to European law.

Targeted measures would definitely go some way towards remedying the tax obstacles currently in place, but even if all of them were implemented, they would not address the fundamental problem of dealing with up to 27 different tax systems. Perhaps as a starting point, they would allow Member States to work together in order to evolve their national systems in a way that helps them coordinate to a higher degree as well as creating an environment in which a common base may become a stronger possibility.

5. Country Analysis

In this chapter I will compare four countries with different systems of corporate taxation in order to show how different Member States deal with losses, and how certain systems have the potential to work with cross border losses.

I have chosen Austria, Denmark, the Netherlands, and the United Kingdom as the countries for analysis as they each have a unique tax regime. Out of the four, Denmark and Austria currently provide for cross border loss relief. The United Kingdom changed their group relief rules after the Marks & Spencer case of 2005 to include foreign subsidiaries under certain circumstances, while the Netherlands had a recent ruling from the CJ on whether their fiscal unity must allow cross border losses to be offset.

31 5 years in France and Italy, and 10 years in Denmark. Austria differs with only a 3 year minimum.
5.1 Austria

Within the European Union, Austria appears to have the most flexible group relief system which came about from a series of wider tax reforms in 2005. Austria has adjusted quickly to CJ case law in the area of direct taxation and can even be considered a “model student” within the EU (Brokelind 2007). When making a comparison of Austria to Denmark (see Table 2) it appears that the domestic tax systems are very similar. The main differences emerge when we come to their treatment of cross border losses. The Austrian tax system provides for cross border loss deduction and a subsequent recapture when profits are once again made. This group taxation regime far exceeds the standards set out by the Court of Justice in the Marks & Spencer case, and can be seen as an attractive tool for tax planning.

Table 2 – Country Comparison

<table>
<thead>
<tr>
<th>Country</th>
<th>Domestic Group Taxation</th>
<th>Loss Carry Forward</th>
<th>Loss Carry Back</th>
<th>Group Taxation</th>
<th>Minimum Holding</th>
<th>Cross Border Group Relief</th>
<th>Method of Cross Border Loss Relief</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>Pooling of group results</td>
<td>Unlimited</td>
<td>No</td>
<td>Gruppenbesteuerung</td>
<td>&gt; 50 %</td>
<td>Yes</td>
<td>Deduction/Reintegration</td>
</tr>
<tr>
<td>Denmark</td>
<td>Pooling of group results</td>
<td>Unlimited</td>
<td>No</td>
<td>Sambeskatning (Joint Taxation)</td>
<td>&gt;50%</td>
<td>Yes</td>
<td>Consolidated profits – comprehensive scheme</td>
</tr>
<tr>
<td>Netherlands</td>
<td>Full consolidation</td>
<td>9 years</td>
<td>1 year</td>
<td>Fiscal Unity</td>
<td>≥95%</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>United Kingdom</td>
<td>Intra group transfer “Group Relief”</td>
<td>Unlimited</td>
<td>1 Year Optional</td>
<td>Group Relief</td>
<td>≥75%</td>
<td>No</td>
<td></td>
</tr>
</tbody>
</table>


In principle, foreign losses of a non-Austrian group member must be utilized abroad. Therefore, foreign losses that are (immediately) utilized in Austria have to then be recaptured in Austria at the time they become usable abroad. This should avoid potential double dipping of foreign losses in Austria and abroad. As a consequence of the foreign loss recapture, the immediate use of foreign losses in Austria is of a temporary nature and
effectively results in a tax deferral in Austria. Final recapture occurs when the foreign group member leaves the group. In this case, the entire amount of foreign losses will be recaptured, regardless of whether it was already offset in Austria (Buzanich and Gatterer 2010). The possibility to use the foreign losses abroad is not taken into consideration in such a final recapture, which is quite different from the ruling in the Marks & Spencer case and shows that it is possible for Member States to make use of such a system in order to offset foreign losses without falling into the problems that were mentioned in the case.

In order to qualify under this group scheme, there must be participation (direct or indirect) of at least 50%, including the majority in voting rights. The members must file an application with the tax office, and the group must be maintained for at least 3 years before they can use foreign losses. Unlike the Danish system, there is flexibility on which companies are elected to be included, and they must remain in the group for three years or the benefits provided by the group taxation are clawed back. Financial control must be exercised throughout the accounting period of the subsidiary (Brodey and Jordis 2005).

As in Denmark, regardless of the participation held, 100% of the profits and losses of the group members will be attributed to the parent company (see Figure 2). But in contrast to that, losses of foreign group members will only be attributed according to the percentage of ownership held (KPMG 2004). Also similar to Denmark, the pooling of profits and losses will allow for final tax savings, and the foreign offsetting of losses will provide cash flow benefits for the group. The pooling regime in Austria requires consolidated financial statements when the companies are over a certain size (KPMG 2004).

Austria’s tax reform was a big step away from their old regime in which more than 75% participation was required as well as the necessity for the parent to exercise economic and operational control of the subsidiary. The reform also brought their corporate taxation rate down from 34% to 25%. The reform was a response to the EU enlargement which brought in many lower tax countries that were in close proximity (Brodey and Jordis 2005).

The Austrian system is still quite new. As it was introduced in 2005, and there is a 3 year period in which a tax group must exist before they can take advantage of the benefits, many
tax groups are now looking at the possibility of reorganization within the tax group without affecting the existence of the tax group to date. Reorganizations in connection with a non-Austrian group member may have the effect that the non-Austrian group member leaves the tax group and foreign losses have to be recaptured. Equally, the decrease in the scale of a business or a qualified part of the business of the non-Austrian group member may have such consequences, therefore careful planning is required. All other measures that have an impact on the business of the non-Austrian group member should also be regularly monitored in order to ensure that a potential creeping decrease in the scale of the business of the non-Austrian group member is timely recognized and that appropriate action may be taken (Buzanich and Gatterer 2010).

5.2 Denmark

Along with Austria, Denmark is one of the few Member States to currently allow cross border loss relief. Under the amended Danish tax consolidation regime from 2004, Danish companies and Danish branches of foreign companies, which are part of the group are subject to mandatory Danish tax consolidation. Foreign branches of Danish companies in the group are not included unless an election for cross-border tax consolidation has been made. Cross border consolidation takes place under the global pooling principle. Under this principle, if used, all foreign group entities (as well as Danish entities) will be included in the Danish tax consolidation group through “all in or all out” criteria meaning that either all group entities are included in the tax consolidation scheme or none of them are (See Figure
3). This limits the possibility for tax planning or cherry picking that would otherwise allow companies to only include loss making entities, although in Austria, we see evidence of a system which allows for election of various companies to be included, yet still manages to avoid negative tax planning issues. The decision to form a cross border tax consolidation group in Denmark is binding for a period of 10 years. In the event the scheme is terminated within the 10-year period, foreign tax losses which have previously been deducted are fully recaptured (Bech-Bruun 2009).

An international joint taxation group must keep records of all used tax losses contributed by foreign entities. These losses will later be reduced if the relevant foreign entity in a subsequent year realizes a taxable profit subject to effective Danish corporate tax, i.e. the Danish tax on the income from the entity after foreign tax credit. The Danish system allows losses to be carried forward indefinitely, and no carry-back is permitted.

All related companies must fall within the definition of group-related companies set out in the Danish Financial Statements Act, and all members must have the same income year as the administration company. The definition of a group-related company includes having a

Figure 3 – Joint Taxation in Denmark

Source: Bech Bruun. Corporate Income Tax
majority of the voting rights in another company, the right to dismiss members of another company’s management, and the exercise of control over another company’s management, among others (Bjørnholm and Pals 2006). The total income of each entity included in the joint taxation is included in the joint taxation income of the group. This will also be the case even if the parent company does not own 100% of the capital of a subsidiary. Only the taxable income or tax loss for the period where it has been a part of the joint taxation group is to be included in the joint taxation income (BDO International Limited March 2010).

The taxable income of the tax consolidation group is computed company by company; therefore each maintains its own legal entity unlike in the Netherlands. Although the income is termed consolidated, there is in fact no consolidation, instead, as mentioned previously, it is a pooling of results. Consolidated income in this case, is determined by calculating the taxable income separately for each member of the group and then pooling the taxable results. However, before the pooling, the taxable results of the members are adjusted by offsetting each member’s losses carried forward (if any) against the member’s taxable result. Losses for the current tax year of a member are transferred proportionally to the profit-making members. Losses that may not be set off against income of profit making members are allocated proportionally to the loss-making members to be set off against future profits of these members. Losses of a member incurred before the inclusion in a local tax consolidation group may be set off only against such member’s own future income (Bech-Bruun 2009).

The administration company is responsible for the payment of all taxes levied on the consolidated income, and the other members of the consolidation group are required to pay their share of the taxes to the administration company. There is a collective liability for all companies to the state for the corporation tax, although once a member has paid its share of the taxes to the administration company, its liability is transferred to the administration company.

The Danish system for cross border loss relief, along with that of France, has been in place longer than many others in the EU and it has therefore been a system of reference from the Commission as a possibility for other Member States.
5.3 The Netherlands

The Netherlands has a unique type of corporate tax groups. Unlike any other Member State, they exercise full consolidation\footnote{In the Netherlands, consolidation refers to full consolidation of the group meaning that all members are treated as one taxable entity, not to be confused with the term consolidation often used by the Commission.} for group relief using a system known as a fiscal unity. Article 15 para. 1 of the Corporate Income Tax Act (CITA) states that if a taxpayer (parent) holds the legal and beneficial titles of at least 95% of the shares in another taxpayer (subsidiary), then at the request of both taxpayers, the tax is levied from them as if there is one taxpayer, in the sense that the activities and the equity of the subsidiary form part of the activities and equity of the parent. This regime was revised in 2003, whereas in the previous tax system 100% ownership was mandatory.

Under a consolidation regime, a corporate tax group is considered to have a single legal personality from a tax point of view and therefore completely disregards the legal personality of each member of the group making all transactions at arm’s length. From a technical point of view, the taxable income and the group members are first computed separately and then the income from the intra-group transactions is neutralized. The sum of this adjusted income is then attributed to the parent, and using one set of accounts the results as well as assets and liabilities of the entities are then aggregated (Princen and Gérard 2008).

The companies must have the same financial year and apply the same rules for the determination of profits. A fiscal unity status allows for tax-neutral restructuring and transfers of assets/losses between group companies as well as the filing of a single corporate income tax return (van den Hurk, van den Broek et al. 2010).

One of the requirements for the formation of a fiscal unity is that all companies must be based in the Netherlands for tax purposes - which can therefore include a Dutch permanent establishment of a foreign company (Ministry Of Finance 2008). This creates a barrier for companies established in other EU Member States as they cannot benefit from the fiscal unity regime, which was confirmed by a very recent ruling from the CJ in the case of X Holding. This case determined that a Dutch parent company and its non-resident subsidiary...
cannot apply for a group tax consolidation if that subsidiary does not have a PE in the Netherlands.

The inclusion of a non-resident taxpayer in a fiscal unity is only related to the extent to which profits and losses are attributable to its permanent establishment in the Netherlands. Profits and losses from the non-residents’ other activities are ignored (Maisto 2008). For foreign elements of income pertaining to corporate income tax, the Netherlands usually apply the exemption with progression method. Under the exemption-with-progression method, the state of residence provides an exemption from its tax for income earned in the state of source, but the residence state retains the right to take the exempt income into account in order to determining the marginal rate at which the taxpayer's non-exempt income is subject to tax. The exemption with progression method prevents a taxpayer from taking advantage of a lower tax bracket in the state of residence by earning income abroad (Krishna 2010). In principle, foreign elements of income are exempt per individual country. Foreign losses decrease the Dutch tax liability in the year they are suffered and when calculating the reduction in subsequent years, are deducted from the positive foreign income qualifying for exemption (Ministry Of Finance 2008).

According to KPMG tax advisory for the Netherlands, the existing rules for setting off losses within a fiscal unity are extensively regulated. In general, pre-fiscal unity losses can be set off only if the fiscal unity as a whole has a profit for tax purposes after setting off the results of the various fiscal unity companies. If the income or profits from foreign sources exceed the total income or total profits (for example because the ‘domestic income’ is negative), exemption may not or may not fully be granted in the year in question for the foreign income. In such cases, the total amount of the foreign-source income respectively the ‘excess’ of the exemption may be carried forward and reduction of tax may be granted in subsequent years. This enables the Dutch tax liability to be reduced in the subsequent years. The same procedure is followed for carrying back the loss incurred by a fiscal unity company to be set off against its pre-fiscal unity profits (KMPG 2008).

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33 Case C-337/08. X Holding BV v Staatssecretaris van Financiën. 25 February 2010
Carry forward of losses in the Netherlands is now limited to 9 years after the tax reforms that took place in 2007. The carry back was also reduced from 3 years to 1 year. However, carry forwards or carry backs may be restricted or denied in circumstances where there is a change of 30 percent or more in the ownership of the company, in what is known as an “important change”. There are also extensive rules that restrict a taxpayer’s ability to carry-forward pre-fiscal unity losses to be set off against post-fiscal unity profits and the same for carry back. Unlike the United Kingdom, there is no limit to compensation of losses generated in one business to the profits of only that business and no other (Müller 2007). The Netherlands had the chance to extend their fiscal unity to include cross border losses during the Marks & Spencer trial. At that time, it was proposed by the State Secretary of Finance that cross border fiscal unities be facilitated, along with the introduction of several conditions to prevent abuse. Not only would it have been an advance for cross border losses, but the fiscal unity regime also eliminates transfer pricing issues, creates tax neutral restructuring as well as eliminating taxation on intra-group dividend payments (Englisch 2010). Many saw this as what could have been a proactive step forward, and are critical of the fact that it was quickly withdrawn when the Marks & Spencer ruling was passed (van den Hurk 2006).

5.4 United Kingdom

UK laws do not provide for group tax consolidation. However, a voluntary group relief system is available. A corporate tax group in the UK usually refers to two or more UK resident corporations with the parent corporation owning directly or indirectly, at least 75% of the ordinary share capital of the subsidiary or subsidiaries as well as 75% of both companies’ profits and assets available for distribution to equity holders in liquidation. As seen in Figure 4, the groups would be H, A and C in one group, while A and B would form a separate group. B is not included with H as the effective interest of H in B is less than 75%.

Group relief surrender of losses is one of the specific provisions relating to groups that recognize the economic unity of interest between group companies (Jones Day 2003). Unlike the consolidation regime found in the Netherlands which has an effect on nearly all aspects found in the Corporation Tax Act, group relief only deals with the offsetting of
losses. It should also be noted that the UK system also has another group taxation system for capital gains taxation for which the threshold is 51% (Fish 2009). Group relief loss surrender is also possible between a consortium group\textsuperscript{34}. Also dissimilar from the Netherlands, members of the group are not treated as a single entity and therefore there is no intention to achieve a single result for the group as a whole.

Group relief is also extended to UK branches of overseas companies and to overseas branches of UK companies in specified circumstances. A UK branch of an overseas company may claim losses surrendered by other UK resident group companies as group relief, or may surrender its own losses as group relief, where those losses are not relievable (other than against profits within the charge to UK corporation tax) in the overseas country. A UK company may also surrender losses which are attributable to an overseas branch if those losses are not relievable in the overseas country. Although non-resident companies were allowed to be included in a group relief group, it was only since 2006, due to the ruling in the \textit{Marks & Spencer} case, that a UK resident parent company may claim group relief for losses of a non-resident subsidiary resident in the European Economic Area (EEA) or the relevant losses of a permanent establishment in the EEA under the same rules as other UK group relief groups, where all scope for claiming non-UK relief for the losses has been exhausted\textsuperscript{35}

There are 4 conditions laid out in the Finance Bill of 2006 in order for a non-resident subsidiary to be allowed to offset losses against the parent company. They are as follows:

1. **The equivalence condition**: requires the loss to be of the same nature as losses that are already allowable under the existing group relief rules.

2. **The EEA tax loss condition**: requires that there is a loss under the rules of the EEA territory of residence of the would-be surrendering company (excluding losses of a UK permanent establishment).

3. **The qualifying loss condition**: requires that the loss is one which can no longer be relieved in the EEA territory of residence, or EEA territory of establishment of the permanent establishment, and has not been relieved in any other territory, and

\textsuperscript{34} A “consortium” exists where between two and 20 companies each hold more than 5% interests, and together hold at least a 75% interest, in the consortium company.

\textsuperscript{35} Finance Act 2006. 7 April 2006. Para 393
4. **The precedence condition**: requires that the loss cannot be relieved in any territory of residence of an intermediate foreign company in the ownership chain between the surrendering company and a UK resident company of which it is a 75% subsidiary.36

These conditions, in particular the qualifying loss condition, create a scenario in which it is nearly impossible for losses to ever be claimed. Because many countries have the possibility of loss compensation in earlier or later years37, it will be difficult in most cases for losses to ever be considered final, especially since the legislation of several Member States provides that even if the foreign subsidiary is discontinued, losses will accompany the discontinued company at the time of its sale (van den Hurk 2006). For this reason, the Commission has issued infringement proceedings against the United Kingdom on the basis that the UK still imposes conditions on cross-border group relief which in practice make it impossible or virtually impossible for the taxpayer to benefit from tax relief. The UK has therefore been requested to amend their tax rules in order to properly implement the *Marks & Spencer* ruling (Ashurst May 2009).

In the UK system there is no “all in” obligation for subsidiaries as there is in the Danish system, although the requirements can differ with the nature of the group relief claimed. There is also no minimum term for the group formation. A trading loss (as adjusted for tax purposes) may be carried forward without time limit to set against profits of the same trade in future periods. Alternatively it may be set against other income (for example, investment income) or capital gains of the same accounting period, or (subject to certain limitations) against income and gains of the preceding year38.

UK group relief is restricted where a company is not a member of the group for the whole of the accounting period. For example, where a company is a member of a group for eight months, only eight months of its losses will be available for group relief. Similarly, only

36 Finance Act 2006. 7 April 2006. SCHEDULE 1 Group relief where surrendering company not resident in UK. Para 4(2)


eight months of its profits can be relieved via losses from other group companies. Losses arising in the gap period (after contract of sale is signed but before actual sale goes through) can only be relieved in the loss-making company, and their use may be restricted if there is a major change in the nature or conduct of the company’s trade within three years of the date of change of ownership (Fish 2009). Each company in a group is taxed as a separate entity, subject to the rules outlined above. However, a “group payment arrangement” may be made, whereby HMRC arranges with some or all the members of a group, for one of them to be the designated taxpayer on behalf of the group.

Trading losses may be carried back for 1 year and forward indefinitely in the same and continuing trade, provided that the company remains within the charge to corporation tax. Any loss carried forward is set off against the earliest available trading profits. Alternatively, a trading loss may be set off against the other income of the company of the same or preceding accounting year and against capital gains of the same year. There are restrictions on the carry-back and carry-forward of losses where there has been a substantial change in the ownership of the company. These restrictions only apply where there is a major change in the nature of the trade, or where the activities of the company’s trade have become small or negligible before the change in ownership takes place, and there is a subsequent revival of that trade\(^{39}\).

**Figure 4 – Structure for Group Relief in United Kingdom**

Source: Fish, Student Accountant. 2009

\(^{39}\) Corporation Tax Act 2010. Part 14- Change in company ownership. Chapter 2
6. Methods for the Elimination of Double Taxation

As we know there are two main methods\(^40\) for the relief of double taxation under tax treaties. The first is the credit method, which is currently the primary method used by Member States of the EU\(^41\) in their tax treaties (Terra and Wattel 2005). Under this method, the residence state is taxed on the basis of the total income, including foreign income. The credit method allows domestic taxes in the resident State to be reduced by the foreign taxes that have been paid in the source State. The full credit method is rarely used as it allows the deduction of the full claim for foreign tax paid. In this case, if the tax level in the source State is higher than that in the home state, the domestic tax would actually be lowered. Instead most countries use the ordinary credit method which limits the deduction of foreign tax to the level of the domestic tax that would have been applicable to the foreign income. The limit is only necessary if the tax rate in the source state is higher than that in the resident state. When that is not the case, a full credit is allowed.

The credit method adheres to the principle of credit export neutrality which presumes that taxation should not affect an investor’s decision of where to invest. The resident state taxes the foreign source income, and then receives a credit of the amount of foreign tax already paid. This protects against unfair tax competition due to the fact that if the source state lowers its rate, the less credit the taxpayer will receive, therefore any advantages that were foreseen by doing business abroad are now taxed away by the home state. On the other hand, it also creates a system in which any sort of tax incentive or reduction in the source state will ultimately end up in the hands of the home-state Treasury, and not the taxpayer (Terra and Wattel 2005). This method works in a similar way to the treatment of losses of domestic establishments, as any loss will be taken into account when determining worldwide income.

As the credit method involves taxation of worldwide income of the enterprise - including foreign branch losses, the losses are consequently offset automatically against other

\(^{40}\) The deduction method is not recognized by the OECD model
\(^{41}\) It should also be noted that the majority of countries within the EU use the exemption method for one major item of foreign-source income, namely dividends received by resident parent companies from their foreign subsidiaries.
income. Crediting of the foreign tax paid will not occur as long as the foreign branch has not made enough new profits to set off its previous losses locally. This method needs to be applied on a per country basis. If the enterprise has several foreign branches, the results of the branches must be aggregated per Member State, but the balances per Member State are not in turn aggregated into a grand balance of total foreign income. The amount of the loss of a foreign branch is then determined on the basis of the tax rules of the home state of the undertaking. The credit method is generally much more complicated to apply than the exemption method (Ault, Arnold et al. 2004).

The second method, tax exemption, taxes only domestic income. The full exemption method, like the full credit method is rarely applied. It involves a full separation between foreign and domestic income for taxation purposes. As a general rule, resident taxpayers with exempt foreign-source income receive more favourable tax treatment than those with only domestic-source income. The current exemption system therefore encourages resident taxpayers to invest abroad in countries with lower tax rates (especially tax havens) and divert domestic-source income to those countries. Some countries have adopted a partial exemption system to avoid this disproportionate outcome, under which a foreign-source exemption is provided only on income derived from countries committed to imposing a tax structure comparable to that of the resident taxpayer's country (Brinker and Sherman 2002).

Due to the complications arising from such a system, exemption with progression is the more commonly used approach, in which the resident state takes the amount of exempted foreign income into account when determining which tax rate will be imposed on home state income. This method falls under the capital import neutrality principle which begins with the view that the resident state should exempt the foreign income as it has already been taxed in the source state (Terra and Wattel 2005). Competition is viewed in a way that the home state should not obscure the playing field on the foreign market by imposing further taxes at home. Overall, the taxpayers home state tax will be calculate on his worldwide income but will then be reduced by the part of the domestic income which can be attributed to the foreign source income.

The full exemption method ignores foreign losses and profits and therefore results in market fragmentation; whereas exemption with progression includes foreign profit and
losses in the base, thus automatically allowing cross border relief, which will later be recaptured when the foreign source becomes profitable once again. The recapture mechanism works in a way that no exemption will be granted for positive foreign income in the following years (as long as these profits do not exceed the losses previously deducted) (Terra and Wattel 2005). The exemption method also places emphasis on the rules of the source state, as the foreign sources income may end up not taxed in either state if the rules are not congruent (Ault, Arnold et al. 2004)

The exemption method respects the tax sovereignty of the source, although that is not the point of such a method. Instead it is aimed at avoiding home-based multinational companies from being subject to a higher tax burden in foreign markets. It is therefore evident that the credit method is often applied by countries with larger markets such as the US, and the UK, while the exemption method is used by countries with a more open market and/or a market that is too small to provide for sufficient expansion possibilities, for example the Netherlands. When tax rates are comparable, the two methods yield nearly the same results.

To analyze the two methods from a perspective of the single market, it appears that the credit method, with its home market focus, is not as easy to reconcile with the concept of a common market as the exemption method would be. A credit system does not create a level playing field abroad when a domestic business expands its horizon. The company venturing abroad must pay attention to the tax consequences domestically and the high level of complexity also makes it a less preferable option. The competitive position of any enterprise in the foreign market could be considerably affected. Meanwhile, the exemption system supports the trend towards a truly global business environment, encouraging businesses to export and trade abroad (ICC Task Force 2003). If an EU-wide standard were to be introduced, the exemption method would be preferred as mentioned in the Ruding Report (discussed in Chapter 3). Restrictions could be put into place in order to control any sort of excessive tax competition that could arise from the use of the exemption method, although conversely it is also stated that it is highly unrealistic to expect Member States to relinquish their choice of method, or for those currently using the credit method to make such a costly switch over to a new method.
7. Cases

Court of Justice case law is the leading influence in the field of direct taxation through the form of negative integration. Case law has shaped European tax law into what is it today. Though it is stated that Member States are free to make their own decisions regarding tax policies within their countries, it is not really the case anymore, as all decisions must be in line with European Law.

Although the focus of this paper is cross border losses - as we analyze the following cases, it is important to note that where a restriction on freedom of establishment results purely from the co-existence of national tax administrations, disparities between national tax systems, or the division of tax jurisdiction between two tax systems, should not fall within the scope of Art 49 TFEU (ex Art 43 EC). In contrast, ‘true’ restrictions, that is to say, restrictions to free movement of establishment going beyond those resulting inevitably from the existence of national tax systems, fall under the Art 49 TFEU prohibition unless justified. In the terminology used above, in order to fall under Art 49 TFEU, disadvantageous tax treatment should follow from discrimination resulting from the rules of one jurisdiction, not disparity or division of tax jurisdiction between (two or more) member states’ tax systems.42

In the current environment, it is not so much about whether a State exercises its taxing jurisdiction that matters, but rather whether the tax treatment has achieved consistency at the level of the internal market. Many times, this piecemeal approach leads us to believe that European direct tax law is going nowhere, or that it is dancing in circles. On the other hand, one must remember that “even if undeniable difficulties arise in reconciling the numerous judgments of the European Court of Justice in the field of direct taxes, European direct tax law is living in a long transitional period, whose duration may be further increased insofar as negative integration is not properly supplemented by positive integration adopted at the level of the Member States” (Pistone 2007).

6.1 Marks & Spencer

The UK was host to one of the most influential cases involving cross border loss relief. The Marks & Spencer (M&S) case of 2005 was the first case involving a Member State attempting to use losses from a foreign subsidiary. This landmark case has been endlessly reviewed and analyzed; therefore I will not reiterate previous writings on the case in this paper. Instead I will focus on what has transpired in the five years after the CJ’s ruling.

Despite its narrow scope of application, the outcome of M&S has been to place allocation of taxing power under the scrutiny of EU Law when it was previously under the exclusive competence of the Member States. This highlights an effort to bring thinking on equal treatment to the level of the Community, that is, the symmetry of the system should be perceived within a cross-border (EU) framework.

The CJ pushed the boundaries of its jurisdiction in this case as they ruled in favour of cross border losses being used to offset profits made by the parent company under specific circumstances. The ruling stated that although the (then) current group taxation rules in the UK were against the freedom of establishment in the EU, the actions of the UK were justified if three criteria were met. The criteria of, (1) the need to protect a balanced allocation of the power to impose taxes between the different Member States concerned, (2) the risk that losses might be taken into account twice and (3) the risk of tax avoidance; taken together were accepted as reasonable justification for the restrictive measures\(^{43}\).

The Court also stated in the Marks & Spencer judgment: “… in so far as it may be possible to identify other, less restrictive measures, such measures in any event require harmonization rules adopted by the Community legislature”\(^{44}\). Member States could take this to mean that they are not required to make any effort towards harmonization, and the only steps they may need to take are to make final losses permissible for cross border relief as was decided in the M&S case.

One of the primary criticisms that arose from the Marks & Spencer case was that the CJ did

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\(^{43}\) Case C-446/03 Marks & Spencer plc v David Halsey (HM Inspector of Taxes). 3 December 2005

\(^{44}\) ibid Para 58
not clarify how Member States should amend their current group relief rules in order to ensure they are compatible with EU law. In paragraph 55 of the M&S ruling, it was stated that the restriction goes beyond what is necessary where a non-resident subsidiary has exhausted the possibilities for having the losses incurred in the Member State where it is situated, for the accounting period concerned, for previous accounting periods as well as the possibility in future periods. The United Kingdom struggled for years in order to determine the proper timing and implementation of allowing the offset of losses by a foreign subsidiary. After numerous hearings and decisions, the “no possibility” test was introduced in order to establish whether overseas subsidiaries had exhausted the possibilities available in their own jurisdictions of having losses taken into account or transferred for use by another entity as per the CJ decision. This test required the subsidiary company to prove that there was absolutely no possibility that the losses could be used in current or future accounting periods, either by itself or by a third party (Ashurst May 2009). Although the decision in itself was a step forward, the exceptions that were introduced in order to meet the criteria to carry losses over are nearly impossible to meet and could therefore be seen as an indirect restriction.

In September 2008, the Commission sent the United Kingdom a reasoned opinion stating that the requirements were in fact too stringent, and that it remained nearly impossible to claim for cross border losses. If the UK does not once again amend its rules, the Commission can refer them to the CJ. Although the Commission has been reluctant in the past to challenge the national tax systems, this could become the trend throughout the EU if the rest of the Member States do not amend their taxation laws in order to comply with decided case law from the Court of Justice. To date the majority of the cases heard by the CJ have come in the form of preliminary rulings from the national courts, but there could be a shift in the future, if no other way forward is agreed upon.

6.2 Oy AA

Although the Marks & Spencer case remains the pinnacle of decisions for cross border loss relief, many cases have transpired in more recent years causing questions in the minds of those involved as to whether the justifications in the M&S case ruling will continue to prevail.
Oy AA refers to intra-company transfers, and the possibility to deduct these transfers from a parent company’s taxable income. In this case, the Finnish parent company made such transfers to a non-resident subsidiary and was therefore denied the option to deduct this amount from its profit. This was seen as less favourable treatment for a Finnish subsidiary with a non-resident parent compared to a Finnish subsidiary with a Finnish parent company. This treatment was allowed based on two out of the original three justifications found in Marks & Spencer namely those of protecting a balanced allocation of taxing power and the risk of tax avoidance. If intra-group cross-border transfers were allowed, this would be tantamount to allowing groups of companies to freely choose any Member State in which to have their profits taxed. This would therefore undermine the system of allocation of the power to tax between Member States. Related closely to this, is the possibility for Member States to transfer income to the Member State with the lowest tax rates therefore elevating the risk of tax avoidance.

Group relief and group contributions can be seen as similar in nature as they both provide for the transfer of losses and profits. The difference then between Oy AA and Marks & Spencer is that M&S dealt with final losses, for which it was not necessary to deny cross border loss relief, therefore there was the possibility for a less restrictive measure, whereas in Oy AA, the Court found that even creating further conditions in order to prevent the aforementioned problems would not be possible. There were no less restrictive measures that could have been applied to ensure that the balanced allocation of taxing powers would not be jeopardized and to eliminate the risk of tax avoidance. Ultimately, the difficulty in allowing cross-border intra-group transfers results from the fact that a Member State that adopts a group contribution system cannot ensure that an intra-group transfer is accorded the same treatment in another Member State as that afforded under its rules since “Member States retain the power to define, by treaty or unilaterally, the criteria for allocating their taxing powers” and this consequently gives rise to disparities between the Member States’ national tax systems operating in parallel (Pizzuto 2009).

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45 Case 231/05. Oy AA. 18 July 2007 para 65
46 ibid para 52
6.3 Lidl Belgium

The Lidl Belgium case was the follow up to Marks & Spencer as there was anticipation to see whether the ruling given in M&S would be upheld by the CJ as it related directly to cross border relief, as well as giving indication as to whether the standards from the previous ruling could be transferred to a branch (permanent establishment).

In Lidl Belgium the Court held that a German tax rule, which denied the possibility of a Germany company to set off losses incurred by its permanent establishment (PE) in another Member State, constituted a restriction of the freedom of establishment in so far as it placed a German company with a foreign PE in a less favourable position than a German company with a German PE47.

The difference between Lidl and M&S is that the losses of the Luxembourg PE in Lidl were not stranded and could have been set off against profits of the same PE. The Court therefore did not demand the granting of cross-border loss relief because the losses incurred could have still been carried forward and relieved in Luxembourg.

The Lidl case was in line with the decision in Marks & Spencer. As the losses were not final, they did not have to be surrendered to the parent company. Although there was a cash flow disadvantage for a company that had a foreign PE versus one who had a domestic PE, the CJ could not force a change in the system to something that would be less disadvantageous, such as deduction and recapture. Regardless of the negative effect, the Court applied two of the three justifications from M&S and the losses were unable to be offset for that given time frame.

The case therefore clarifies certain aspects from the Marks & Spencer principle such as the fact that two out of the three original justifications can be seen as sufficient to constitute

47 It should be noted that if the nature of a permanent establishment is traditionally understood, the profits of a PE are always taxable in the host state where that PE is established, and losses would normally be carried forward in the host state to set against subsequent profits. Equally, because the PE is part of the same single taxpayer, the profits of the PE would normally be integrated with the profits of that taxpayer in its state of residence, and equally losses would be integrated. It was only the provisions of the Germany-Luxembourg double taxation convention which prevented this integration both of profits and of losses.
overriding reasons in public interest. Although two justifications were also permitted in OY AA, that case was not directly related to cross border loss relief, therefore Lidl offered further clarification. It was also stated in Lidl that there could be a wide variety of situations in which a Member State could put forward reasons…”it cannot be necessary for all the justifications referred to in paragraph 51 of the Marks & Spencer judgement to be present in order for national tax rules which restrict the freedom of establishment…to be capable, in principle, of being justified”48. Though the question remains whether a mix of a different two of the justifications could also be used, since this case concerned a branch, not a subsidiary, therefore eliminating the possibility of tax avoidance (Kessler and Eicke 2008). On the other hand, the judgment offers no guidance as to when a possibility will be exhausted, given that in this case the losses had been used within a four year period (Dorsey & Whitney LLP 26 May 2008)

6.4 Philips Electric

The Philips case is an important ruling as it is a decision made by a UK court without a reference to the CJ. In this case, the group of which the Taxpayer (UK resident) was a member, had invested in a joint venture structure through Dutch and German companies. Together the group held over 50% in the joint venture company. The taxpayer made various consortium relief claims in relation to the losses of the UK branch of a Netherlands company (see Figure 5).

The HMRC argued that the surrendering of the losses was prevented due to two restrictions in the rules on surrender. The first restriction, in the rules on consortium relief, states that the direct investor in a joint venture company needs to be a UK resident company (or at least a non resident subject to corporation tax) for losses in the joint venture group to be surrendered to members of the investor group49. The second restriction states that losses of UK branches cannot be surrendered (by way of group relief or consortium relief) if they are available to be used overseas50.

48 Case C-414/06 Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn. 15 May 2008. Para 40
49 Income and Corporation Taxes Act 1988. Section 406 on link companies
50 Ibid. Section 403D(1)(c)
It was decided by the UK court that these restrictions were against the freedom of establishment, and possible justifications were then analyzed. No justifications for the first restrictions were found, and the only objective identified by the CJ that is conceivably relevant to the second restriction is the elimination of the prospect of the double use of losses, but the HMRC failed to convince the Tribunal that this justification could be used. There is no risk of UK losses being used twice in the UK (because of section 411 on the exclusion of double allowances). The only theoretical possibility is that UK losses might be used both in the UK and in another Member State. To compare the *Marks & Spencer* justifications that have been upheld in various cases, we can see that the prevention of the double use of losses has never been upheld on its own as a justification for a restrictive measure. Although *Lidl* and *OyAA* demonstrated that all three justifications are not necessary, the common theme throughout the cases is the balanced allocation of taxing rights.

In the current case, the UK, as source state, does give relief for losses by carry forward (or backwards) and therefore it cannot justify not giving relief for losses of a branch in one particular circumstance of group relief, when a subsidiary is permitted to relieve losses in this way. The use of losses of a branch cannot therefore in our view jeopardize the balanced
allocation. The restriction imposed by s 403D(1)(c) is accordingly not justified\textsuperscript{51}.

The Tribunal decided that in order to win, the HMRC also had to be able to show that the restriction was justified on the basis of the balanced allocation of taxing powers. This was not the case because the UK, as source state, had the primary right to tax profits and to relieve losses and it did not matter whether the losses were also used in the Netherlands, even if that meant double use of losses. They then went on to see if this decision was proportionate, which they found it not to be, as it was contrary to the \textit{M&S} case which required there to be no possibility of use of losses overseas for group relief.

The outcome therefore stated that if the provision is not simply disapplied in certain EEA situations – as the court thinks it should be; then words should be read into it to make it a less restrictive measure in the form of a no possibilities test, as seen in \textit{Marks & Spencer} (Powell 2009). Although a less restrictive measure was suggested by the defense, the Tribunal rejected it on the basis that many less restrictive measures had been suggested in previous cases yet the CJ rejected all of them\textsuperscript{52}.

From the ruling of this case there is evidence of a national court taking the previous CJ rulings and applying them to direct taxation without a reference for a preliminary ruling. They are in effect changing their own tax laws to become more compliant with European tax laws.

\textbf{6.5 X Holding}

The most recent case involving cross border losses was that of \textit{X Holding} in the Netherlands.

As mentioned in Chapter 5, the Netherlands employs a consolidation tax regime in which companies form a fiscal unity and are thus treated as one single taxpayer. The final provision for a company to enter into a fiscal unity is that if they are a non-resident

\textsuperscript{52} ibid Para 45, p 53
taxpayer, they must have a permanent establishment in the Netherlands. A non-resident taxpayer who has no permanent establishment in the Netherlands (such as the Belgian subsidiary of X Holding) cannot be included in a fiscal unity. In fact, only companies which are liable for tax in the Netherlands may be included in the fiscal unity.

While Lidl Belgium in fact referred to a permanent establishment, and not a subsidiary, one may see it difficult to compare the cases, yet because in the Netherlands’ system the subsidiary, if it is included in a fiscal unity, is given the same treatment as a permanent establishment – then on this point, there is no difference between X Holding and Lidl Belgium.

Once again, the argument appeared that the legislation should provide for a more proportional system that allowed a non resident subsidiary to have its losses taken into account in the Netherlands (at the headquarters in the Netherlands) as is allowed for foreign permanent establishments, with a recapture provision that would allow the losses to be calculated again in the profit at the moment the subsidiary made profit (at a later date). As this had been seen in previous cases, the Advocate General (AG) observed that although the Member States were at liberty to introduce such a rule, they were not obliged to do so. The AG referred to the Lidl Belgium judgment in which the CJ had indeed so ruled.

Although differential treatment of a subsidiary established in the Netherlands, versus one established in another Member State was against EU law, it is justified by the need to preserve a balanced allocation of the power to tax between Member States as introduced in the Marks & Spencer case. This concept refers to the necessity to allocate and match within the same taxing jurisdiction. As the Court of Justice stated in M&S, profits and losses are two sides of the same coin, and therefore tax base increases and connected tax base reductions must be treated symmetrically within the same tax system (Terra and Wattel 2008). The ruling in X Holding also had some similar features to Oy AA, as seen from the need to preserve a balanced allocation of taxing power and the fact that in both

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53 Case C-446/03 Marks & Spencer plc v David Halsey (Her Majesty’s Inspector of Taxes). 13 December 2005 para 43
cases the only reason why the loss (or tax in the case of Oy AA) deductibility was disallowed was due to the nationality requirement.

The justification differs from both *Marks & Spencer* and *Lidl*, as now only one of the three original justifications from M&S is considered sufficient. Many other comments on the *X Holding* case mention the fact that the CJ did not take into account the other advantages of a fiscal unity, as did the AG, Juliane Kokott, in her Opinion. The case also did not refer to final (terminal) losses seen in *Marks & Spencer*. In this author’s opinion, the reason for not referencing these issues is the fact that they were not included in the question referred to the Court. The question itself relates to the possibility under EU law for a parent company to form a single tax unity with a non-resident subsidiary even when the profits of that non-resident subsidiary are not subject to the fiscal legislation of the Member State in which the parent resides. The CJ answered this question by stating that the fiscal unity regime in the Netherlands does not go against EU law by disallowing a non-resident subsidiary to enter into a fiscal unity. The focal point of this case is about entering into a tax scheme, which came about from the fact that the parent company wanted to offset the losses from its non-resident subsidiary. The questions referred in both *Lild Belgium* and *Marks & Spencer* relate directly to offsetting losses, and therefore the Court answered in relation to losses for those cases. *X Holding*, therefore, by nature of the question referred, does not touch upon final losses, nor does the Court need to focus on the other advantages that could arise from such a tax system. If the situation occurred regarding a Dutch fiscal unity and the potential inclusion of terminal losses, then it is highly likely that the same decision as *Marks & Spencer* would arise as the situations of the non-resident subsidiaries were very similar (O’Shea 2010). The situation could also be different if a case would come up regarding the possibility of other benefits of the consolidation regime being attributed to foreign subsidiaries. It can therefore be seen that the *X Holding* case does not clarify the situation found in *Marks & Spencer* in regards to final losses and the no possibility test.

Although based on the CJ’s verdict in the *X Holding* case, the Dutch government does not need to take any legislative action, if they were to introduce new legislation on a cross-border fiscal unity, it may have a positive effect on the Dutch investment climate. As a

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54 Case C-337/08 *X Holding BV v Staatssecretaris van Financien*. 25 February 2010 para 15
result of a cross-border fiscal unity, all entities within a group would be treated as one single taxpayer. Thus, cross-border fiscal unity legislation may further improve the Dutch investment climate, since all transactions within the fiscal unity, including but not limited to group financing, leasing and licensing, would be tax-neutral from a Dutch corporate tax perspective. In this respect, the fact that the Dutch government in December 2009 both abandoned its plan for a mandatory group interest box and announced plans to limit the deductibility of permanent establishment losses might form a good basis for new legislation introducing a cross-border fiscal unity (Merks and Schwarte 2010).

6.6 Case Summary

Throughout a succession of cases, the CJ has supported cross-border loss relief in only a very limited number – no doubt much to the relief of Member States. Many tax lawyers have said that they are surprised by the rulings from the CJ. But the recent rulings have been very much in line with economic efficiency arguments and removing obstacles to cross-border activities. Given the freedoms declared in the Treaty, CJ rulings on taxation should not come as big surprises (Andersson 2005).

The Court of Justice in its decisions in the field of taxation does not take into account how the outcomes in the cases in question fit in with the rest of the tax structure. Although it is up to Member States to design their own tax systems, by applying the Treaty, the Court goes beyond the purely nationalistic views often taken by Member States in their tax policy. The effectiveness of the rulings can then be found in the implementations by each country.

In many cases we have seen that country’s opinions, along with those of the Commission and the Advocate General suggested that the Court should take a proactive stand and introduce the option of changing the tax system in such a way as to create less restrictive measures. The Court rejected such arguments in every case, and has been criticized for such actions. To look at the original power and role given to the CJ, it is stated that “since the establishment of the Court of Justice of the European Union in 1952, its mission has been

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55 Many plans in the Netherlands have currently been put on hold due to the collapse of the government in 2010.
to ensure that the law is observed in the interpretation and application of the Treaties”\textsuperscript{56}. The Court therefore, amongst other roles, interprets European Union law at the request of the national courts and tribunals. In the recently signed Lisbon Treaty, it is reiterated that the Court of Justice shall have jurisdiction to give preliminary rulings concerning the interpretation of the Treaties\textsuperscript{57}. In the “Notices from European Union Institutions and Bodies for the Court of Justice”, it is stated that:

“Under the preliminary ruling procedure, the Court’s role is to give an interpretation of European Union law or to rule on its validity, not to apply that law to the factual situation underlying the main proceedings, which is the task of the national court. It is not for the Court either to decide issues of fact raised in the main proceedings or to resolve differences of opinion on the interpretation or application of rules of national law”\textsuperscript{58}.

It is therefore quite clear that the Court is not expected to give a direct action plan to the Member States who request a preliminary ruling. The criticisms are therefore unfounded, as the Court of Justice is simply interpreting the law, and not applying it to a situation.

The instances in which they do make a suggestion are those where an option already exists that can provide the answer for a less restrictive measure, such as using the Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance to gain information on another tax jurisdiction\textsuperscript{59}. Although the Court explored the boundaries of the application of the Treaty freedoms in the \textit{Marks & Spencer} case by introducing the no possibilities theory for losses, they did not in fact tell the UK how to implement this idea, and they left the interpretation very broad and open.

The Court is simply not able to extend further into the direct taxation regimes of the Member States. As mentioned in nearly every tax case, the fact that there is no harmonization in the field leaves Member States with their power to define the criteria for allocating their powers of taxation, although they must, nonetheless, exercise that competence consistently with Community law.

\textsuperscript{56} Retrieved from curia website \texttt{http://curia.europa.eu/jcms/jcms/Jo2_6999/}
\textsuperscript{57} Art 267 TFEU (Ex Art 234 EC)
\textsuperscript{59} This was found to be true in Case C-418/07. \textit{Societe Papillon v Ministere du Budget}. 27 November 2008.
Even if the case law of the CJ was to evolve into something that was clearer or gave more direction, the situation is far from being satisfactory due to two main issues. The first is the high degree of legal uncertainty, both for taxpayers as well as national legislators. Even when the case law is clear, it remains difficult to predict the compatibility of national tax systems with Community law. Secondly, if the case law of the CJ can strike down national legislators, it cannot build up a system which will be compatible with the single market. So it remains true that the only form of visible integration is negative, through the abolishment of incompatible systems without any construction of an acceptable alternative; (Wathelet 2004) until Member States decide to work together for form a co-operative foundation for direct taxation.

The process of negative tax integration through the case-law of the CJ has its limits in terms of constitutional constraints, legal certainty, economic efficiencies and pace of the integration process. Even so, it has brought the European project to what it is today – seen by some as a success story in making progress, yet having to deal with occasional crises and overcoming numerous challenges. (Hinnekens 2006)

8. Possible Options for the Future

There have been many suggestions for possible ways forward in the treatment of cross border losses besides those from the Commission mentioned earlier in this paper.

Of course the main option is the introduction of a system of deduction and recapture, as used in Austria. The Member States should allow the use of foreign losses in the year they are incurred, provided the parent companies pay back the benefit when the losses are later used in the subsidiary’s residence country. If the country has a loss compensation system and uses a credit system (like the UK), compensation can take place by deeming income in the year the losses are used twice, in the amount of the losses; whereas if an exemption system is used, compensation can take place by denying the participation exemption for dividends until they exceed the amount of the imported losses (van den Hurk 2006).
In the *Philips Electric* case the suggestion for a less restrictive measure for the elimination of double use of losses was to simply preclude the use of losses that have already been set off against profits overseas\(^{60}\). This suggestion could be used by the UK to once again change their rules on the “no possibility” test as they have now been ordered by the Commission to make modifications.

The system used in the Netherlands within their fiscal unity regime could also be applied, in which only the profits and losses that are attributable to a non-resident’s permanent establishment are taken into account. Profits and losses from the non-residents’ other activities are ignored which would eliminate the possibility of the double use of taxes (Maisto 2008). This would have to also be extended to include non-resident subsidiaries in order to be fully compatible with EU law.

Another perspective can be found in what can be called the Schumaker principle. In the Schumacker case\(^{61}\), the assessment was purely practical in the fact that Mr. Schumaker did not received allowances, not because he earned insufficient income in Germany but because in his case the source of that income (funding from his parents and the State) rendered it exempt from German tax. If the *Marks and Spencer* case can find its origin in the Schumaker principle, it should logically follow that a practical test applies to establish whether a loss should be beyond possible use. This would be more difficult to implement as it would be hard to form solid guidelines on how to use this principle. Instead, in relation to the *M&S* test, national provisions should be introduced that determine the exact point at which losses become beyond possible use. This is precisely the position advocated by the Commission in its proposed Directive from 1991 on cross border losses and its recent Working Paper of December 2006 on the same topic, both suggesting a six year claw back period (Mullaly 2008).

If we look at the tax systems of various countries for a solution, we see there are different possibilities. Austria uses a deduction and recapture method which has been chosen by many as the favoured option for offsetting cross border losses. Their system is flexible yet


\(^{61}\) Case C-279/93 *Finanzamt Köln-Altstadt v Roland Schumacker*. 14 February 1995
cautious, and the lock in time is not as long as that of Denmark. The Danish system has been suggested as an option for other Member States in the Commission Communication “Towards an Internal Market without tax obstacles” of 2001. The system has a built in tax avoidance system, as companies are not allowed to choose which foreign entities can be included. On the negative side, the “all or nothing” system is highly inflexible, and has a binding period of 10 years. These requirements have lessened the appeal of the cross border system, and it is currently not used by many corporations.

The Dutch fiscal unity system has many advantages, but the lack of a cross border option for subsidiaries rules it out as an option going forward. To implement a fiscal unity that included non-resident subsidiaries may be a system that would work splendidly, and could be used by other Member States. The elimination of transfer pricing issues, an easy transfer of profits and losses, along with many other attractive features puts the system at the top of the list for compatibility with the Single Market.

The UK group relief regime seems to continually be catching up with the regulations of the EU, as many other country tax regimes would be if more cases were referred to the Court of Justice. Perhaps a radical change in national taxation (as Austria did) in order to be in line with EU objectives is the best way forward for such Member States, as they do not seem willing to work together to form a common tax structure.

This leads us to the possibility of the Common Consolidated Corporate Tax Base (CCCTB) – a much discussed yet seemingly impossible pan-European tax base. This is a topic that can be discussed and argued at length and that is not the focus of this paper but I will mention some possibilities of how this system could work in regards to the analysis found throughout this paper.

The European Commission has proposed that Member States should allow cross-border loss relief in a far broader range of circumstances than the CJ has allowed. Cross-border loss relief is one of the potential advantages of the CCCTB regime for multinational corporations (Dodwell 2008), which was expected to be presented to the Council of Ministers at the Ecofin meeting in September 2008 however it was postponed due to the
necessity for more detailed analysis. Some of the details that need to be sorted out include the definition of a group, agreeing upon a common formula, how to deal with bilateral tax treaties already in place, whether it be mandatory or compulsory, and the overall likelihood of having 27 national systems amend their rules to make the entire arrangement work. It is a huge task, and most are highly skeptical that it will ever become a reality.

Looking at losses in regard to a potential CCCTB, there seems to be agreement that losses should remain outside of consolidation, meaning that they remain at the level of the group member which incurred them. The losses will then be set off against the part of the CCCTB attributed to that group member\textsuperscript{62}. This follows the principles that are currently used in countries applying consolidation or pooling, as seen in the Chapter 5 of this paper. For the time being, it may be more beneficial for companies if the Member States change their group relief rules in order to accommodate cross border tax relief, although this may present tax avoidance opportunities as they could save a significant amount of tax by transferring losses to higher tax areas (Rodrigues 2009). Certain risks will always be present, but there are anti-avoidance instruments that can be put into place to ensure this does not occur.

The CCCTB panel also believes that an all-in system, such as that in Denmark would be the best option to avoid tax planning opportunities, although we can see from the Austrian example that a system can also work without it. Overall, the CCCTB has much work to be done, and ultimately rests in the hands of the Member States for a unanimous vote. There are suggestions for enhanced cooperation\textsuperscript{63} by a subgroup of Member States who wish to use it, but what sense is a common tax base if only some members adhere to it?

The other option presented by the Commission, that is intended to work in conjunction with the CCCTB is Home State Taxation (HST). This system is focused on the small and medium sized enterprises (SME’s) as it is obvious that the risk of losses, especially in the start-up period when this risk is highest, may compel them to refrain from any activity in

\textsuperscript{62} Taxud E1 OP/RP. Common Consolidated Corporate Tax Base Working Group. 23 November 2006
\textsuperscript{63} Enhanced cooperation allows those countries of the Union that wish to continue to work more closely together to do so, while respecting the single institutional framework of the Union. Retrieved from Europa Glossary.
another member state due to high start up costs and the small market in their home state. Through this system, each company would be allowed to compute their tax profits according to the tax rules of the home state of the parent company or head office. The scheme is based on the idea of voluntary mutual recognition of tax rules by EU Member States. Under this concept, the profits of a group of companies active in more than one Member State would be computed only according to the rules of one company tax system (European Commission 2010).

Although the HST could solve some of the current problems, especially in the case of SME's, it would still take considerable implementation time and efforts, and would inevitably stumble upon many unforeseen obstacles. The amount of time and energy put into it could instead, have easily been invested in the further development of the CCCTB which in the end creates an actual cooperative base. A formula is still necessary for the HST, treaties may still need to be renegotiated, and changes would have to be made in order to switch over. It is a large task at hand, and perhaps the focus should be given to the implementation of something that coordinates the tax systems in the long run.

The European Union has achieved things that many thought impossible in the past, including the introduction of the Euro. This leads us to believe that one can never say never in the case of a common tax base, yet it is most certain that if it does come about, it will only be in the distant future.

The way forward does not necessarily mean common rules, as that would be very hard to agree upon unanimously, but at least a common system which would make the national systems compatible with each other and with Community law.

The Code of Conduct created by the Member States themselves acknowledged the harmful tax measures which would distort the choice of location of business in the EU. Although these were only a political commitment to abolish measures deemed harmful, we can at least see that there is recognition that tax matters cannot remain solely at the discretion of each Member State (Wathelet 2004).
9. Conclusion

This paper has showed the degree to which the lack of cross border loss relief within the EU is creating obstacles to the completion of the internal market. By analyzing countries’ group taxation systems, methods for the elimination of double taxation, and case law from the Court of Justice, it has introduced possible options for targeted measures on cross border loss relief. The paper also demonstrated how the Court of Justice plays an important role in shaping the area of direct taxation through case law, with a focus on cases involving cross border losses. There are many possibilities for Member States to align their system with European guidelines, yet the question remains as to what is actually achievable when working with 27 national systems, each of which views taxation as the centre of their sovereignty.

Although many see the CJ’s decisions and the Commission pushing for a consolidated tax base as an attempt to eliminate tax sovereignty, there is also the other side of the coin that Member States have committed themselves to the common market, and with it many changes and adaptations have emerged. In effect, they have signed over their sovereignty on any one topic to the European Union, who will act in its power to ensure an internal market free of any obstacles, one of which is taxation.

By creating common EU rules, costly mismatches between national systems could be eliminated, as well as the reduction of compliance costs for enterprises operating in more than one Member State. Having three players in the mix creates further complications and discrepancies, as the business community who wish to globalize and expand into other countries supports tax coordination, while the Member States represented by revenue authorities, wish to guard their revenue base and are wary of change. The introduction of a common tax base would create winners and losers which of course divides the field into two conflicting opinions. The Commission, representing the EU, has a goal to formulate policy and make sure that agreements are reached (Radaelli and Kraemer 2007). Strategies have changed over the years, but with the introduction of the Lisbon Treaty, it is clear that an internal market free of obstacles in order to become a main competitive global actor is their current goal. We must also include the influence of the Court of Justice, who is
creating an erratic set of guidelines for direct taxation that is making progress on some aspects, yet is also making the entire situation even more convoluted for all involved.

The way forward will be time-consuming and complex, yet it is apparent to most that some sort of change is necessary in the field of direct taxation, and in particular for cross border losses. Whether it is through national tax reforms, targeted measures introduced by the Commission or the eventual achievement of the CCCTB, Member States of the European Union need to coordinate their tax bases in order to work together, and carry out the obligations laid out in the Treaty.

As the European Commissioner responsible for taxation in 2010, Algirdas Semeta, stated:

“The path to economic stability and growth will not be easy, nor will the tax reforms that must pave this path. As with any major changes, it will take effort and commitment from all parties to bring about improvements. But I believe there is a new momentum behind the European tax agenda, fuelled by the recognition that we cannot reach our objectives my maintaining the status quo, nor by acting in isolation. If we harness this momentum and work closely together as a Union, I truly believe that we can delivery quality taxation that is fair to citizens, businesses and Member States preserve the European social model and contributed to innovative, future-oriented growth.”(Semeta 2010)
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Annex 1

Distribution of Total Tax Burden – European Union 2007