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Seeking relief abroad: the use of losses of foreign subsidiaries and permanent establishments

Session Chair

Willard Taylor *Sullivan & Cromwell, New York*

Speakers

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Seth J Entin *Greenberg Traurig, Miami*
Leonardo Homsy *Campos Mello, Pontes, Vinci, Shiller, Rio de Janeiro*
Xenia Legendre *Hogan & Hartson, Paris*
Rob de Win *Van Doorne, Amsterdam*

The third panel of the Bonn conference discussed various issues regarding the use of losses of foreign subsidiaries and permanent establishments. Moderated by the conference's Co-Chair Willard Taylor, the panellists developed solutions for cross-border tax consolidation on the basis of case studies.

Subtopic 1: consolidation of profits and losses between a branch and a subsidiary

Under Subtopic 1, Torsten Engers and Leonardo Homsy talked about the consolidation of profits and losses between a branch and a subsidiary. The panellists came to the conclusion that under the laws of the countries represented at the panel no consolidation of losses between a branch and a subsidiary is possible without further structuring. There is a basic principle under which no (automatic) consolidation of different taxpayers exists, even if they are members of the same group.

Under German law, a consolidation can be achieved by the implementation of a fiscal unity between the (German) branch and a (German) subsidiary whereby the subsidiary must be held by the branch. Under the profit and loss transfer agreement the taxable income of the subsidiary will be allocated to the taxable income of the (foreign) parent company (W Corp) generated via the branch. It should be noted that there are certain requirements for the creation of a German fiscal unity. Further, the transfer of shares in the subsidiary to the branch may trigger taxes in the residence country of W Corp.

A second solution under German law would be the contribution of the branch into the subsidiary in exchange for new shares. Then, taxable income of the branch becomes part of the taxable income of the subsidiary.

A third solution for Germany constitutes the contribution of the branch and the shares in the subsidiary into a (German resident) intermediate holding in exchange for new shares. Between the intermediate holding and the branch and the subsidiary a fiscal unity can be implemented. As a consequence of the fiscal unity between the intermediate holding and the subsidiary, taxable income of the subsidiary is allocated to income of the intermediate holding which includes income generated in the branch.

A fourth solution for a consolidation under German law constitutes the transformation of the (German) subsidiary into a (German) branch. This can be achieved by merging the subsidiary into W Corp. Then, the taxable income of the already existing (German) branch and the new (German) branch are consolidated. A merger is legally possible and tax neutral if Country A is an EU or EEA Member State and assets of the (German) subsidiary are attributed to the new (German) branch.

In Brazil, no consolidation rules are acknowledged. The use of losses may be achieved through a merger transaction. Although Brazilian legislation does not allow the surviving entity to use the losses of the merged entity, it does not prohibit the surviving entity from using its own losses against the profits of the merged entity. The surviving entity must be the one holding the losses.

A second solution might be found in Brazil either by the assignment of assets and liabilities from the loss bearing entity to the other entity, or by a partial spin-off from the loss bearing entity followed by a merger.

Subtopic 2: cross-border use of losses

Under Subtopic 2 Xenia Legendre and Rob de Win discussed the cross-border use of losses. Thereby, it was understood that between Country A where W Corp is resident, and Country E where a branch and/or a subsidiary are resident, a treaty following exemption method shall apply.

Under French tax legislation the use of foreign branch or subsidiary losses is generally not possible. However, some exceptional rules may become applicable as temporary incentive measures to face the economic crisis. Thereby, a recapture during the subsequent five years will be expected.

Under Dutch law the use of foreign branch losses is possible, recapturing rules will apply. A consolidation with foreign subsidiary losses is, however, not allowed.

Brazil denies the cross-border use of branch or subsidiary losses. The situation in Germany is very much comparable to that in France and in Brazil. The exemption method applies for both/profits and losses.

In the US, foreign branch losses are deemed to be US source income and, consequently, are usable within certain limits. Foreign subsidiary losses may be used in the US under the check-the-box regime.

Subtopic 3: acquisition indebtedness

Under Subtopic 3 Seth J Entin presented various tax planning aspects with respect to acquisition indebtedness from a US perspective.

For 'home country planning' from a US perspective it was understood that W Corp is US resident and that Target Co is a resident of Country E. The problem for outbound planning is an unusual excess of foreign tax credits. A first (classic) acquisition structure aiming at the avoidance of an excess of foreign tax credits constitutes the acquisition of Target Co via an Acquisition Co resident in Country E. Debt shall be 'pushed down'. Crucial questions are whether Country E allows a push down through consolidation, group relief or merger.

A double dip acquisition structure can be achieved by imposing a hybrid Acquisition Co that is regarded non-transparent in Country E but – under the check-the-box rules – transparent under US tax law. W Corp grants a loan to Acquisition Co to allow interest deduction at the Acqusition Co level but even under US consolidated loss rules. Although this route is an accepted technique, it is not yet clear if it will be affected by new Obama proposals.

Another way to achieve the goal is the interposition of a holding company in a low tax country between W Corp and the hybrid Acquisition Co W Corp grants a loan to the holding company that on-lends to Acquisition Co. This structure may – under current law – avoid adverse CFC consequences, but is under attack by Obama administration.

Imposing a hybrid instrument between W Corp and Acquisition Co constitutes the final frontier. The hybrid instrument is regarded as debt for Country A but as equity for US tax purposes. This structure is not under attack by the Obama administration.

Opposite to home country planning, 'target country planning' is generally not under attack by the Obama administration. For inbound planning purposes the 'classic' acquisition structure where the Country A resident W Corp grants a loan to the US resident Acquisition Co is frequently used. The US allows push down through consolidation filings or a merger.

A hybrid US resident Acquisition Co can be achieved through a Delaware LP that is considered a pass-through entity in many countries but a corporation for US tax purposes. This structure may facilitate a double dip.

Again, the imposition of a hybrid instrument can be seen as the final frontier. One technique used is a repo transaction where the non-US resident W Corp and the US resident Acquisition Co enter into a contract for a mandatory buy back regarding preferred shares for a fixed price. Dividend payments under the repo are treated as debt for US tax purposes but as dividends in many other countries and so may facilitate a double dip. The panel came to the conclusion that in particular the US and the Netherlands offer many possibilities for hybrid acquisition structures.