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FEATURED PERSPECTIVES

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The life of losses can be adventurous. Maybe not as adventurous as a journey on a boat with a tiger, but interesting nonetheless. That is especially true when it comes to the cross-border travel of losses within the EU if the travel is triggered by a merger. The journey started in Sweden: A 100 percent Swedish-held subsidiary that incurred losses over the years was merged into its Finnish parent company. After the merger, the parent left behind no operations in Sweden, in particular, no permanent establishment. A ruling request of the parent asking whether the losses incurred by its merged Swedish subsidiary arrived in Finland in order to offset profits of the parent led to proceedings at the European Court of Justice,[1] because the fiscal authorities did not allow the transfer.

Violation of Freedom of Establishment

When losses start their journey from one member state (Sweden in *A Oy*) to another (Finland), it does no good to look to the merger directive[2] since it does not help them cross the border. Article 6 of the directive only entitles the receiving company to take over losses from the transferring company if the transfer is allowed in a purely domestic situation and, as a second requirement, if the receiving company keeps a PE in the member state of the transferring company. Since *A Oy* did not have a PE in Sweden after the merger, the merger directive did not help a utilization of the Swedish losses in Finland.[3]

Because secondary EU law (the merger directive) did not provide for a transfer of the losses, the ECJ turned to the question of whether disallowing a transfer of losses from Sweden to Finland violated the freedom of establishment. The Court performed a comparison in order to give an answer:[4] It concluded that if losses could be transferred in a purely domestic merger, the transfer had to apply as well in a cross-border situation within the EU, unless an overriding reason in the public interest justifies a discrimination.[5]

Surprisingly, the ECJ, before going into detail about its justification test, accepted the argument of the German and U.K. governments that no loss transfer should be possible as a consequence of the cross-border merger if the sole motive of the merger was to obtain a tax advantage. The reason for accepting this argument was the domestic Finnish law, which disallows a loss transfer in a purely domestic context if the sole reason for a merger was to obtain a tax advantage. Obtaining a tax advantage in a purely domestic situation, however, is much different from obtaining a tax advantage in a cross-border situation, which is why the Court should not have accepted this sole motive route in an

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[1] *A Oy* (C-123/11), Feb. 21, 2013; Opinion of Advocate General Julianne Kokott on *A Oy* (C-123/11), July 19, 2012.

[2] Council Directive 2009/133/EC of Oct. 19, 2009, on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States.

[3] Terra and Wattel, *European Tax Law* 2012, p. 674.

[4] Helminen in Lang (ed.), *ECJ — Recent Developments in Direct Taxation* (2011), p. 83; *A Oy*, para. 35.

[5] *A Oy*, para. 38.

EU context. This is obvious from the fact that tax disadvantages are often caused because of a cross-border situation and that, for exactly this reason, a transaction leading to a tax advantage cannot be measured with the same standards as a transaction in the domestic context. Therefore, the ECJ should not have bestowed it on the national court to decide whether the sole motive in the *A Oy* case was obtaining a tax advantage, but should instead have referenced its own case law according to which national discriminatory measures against possible tax law abuses may only be upheld if wholly artificial structures were aimed at by the taxpayer.[6] The case law would not allow a discriminatory measure only if the sole motive of the taxpayer was gaining a tax advantage.

After the ECJ's excursion into the sole motive terrain, the Court — stating that the underlying ruling request did not contain enough detail to judge what the motives of the taxpayer were — turned to a more concrete justification test. It tried to determine whether not allowing the transfer of foreign losses may have been justified in order to:

- preserve the allocation of the taxation power among member states; or
- prevent the double use of losses.

The Justification

Regarding those two justifications, the ECJ arrived at the same conclusions already made in cases such as *Marks & Spencer*,[7] *Oy AA*,[8] and *Lidl Belgium*[9]: If the foreign losses such as those at stake can no longer be used in the country where they originated, a deduction of those losses may have to be granted in the residence state of the parent or — if the losses are in a PE — in the state of the head office. This brought up the decisive question: When may the possibility to use losses be considered to have evaporated in the state where they originated? Is the possibility to use the losses abroad understood as a mere legal possibility, as an economical likelihood, or is it in the discretion of authorities or a court to decide that issue?[10] Some academics in Austria and Germany believed that only an actual impossibility to use losses abroad requires the other state to allow for an import of those losses.[11] Good arguments, however, supported the position that the mere economic probability should be decisive for whether a loss transfer is necessary in light of EU law.[12] In the ruling of *A Oy*, the ECJ authorized the national court to make the call whether the losses could still be used abroad when it stated that:

> [were] the referring court to reach the conclusion that such proof has been produced, it would be contrary to Articles 49 TFEU and 56 TFEU [note: freedom of establishment and freedom to provide services] for A to be denied the possibility of deducting from its taxable profits in the member state concerned the losses incurred by its non-resident subsidiary, in the context of the merger at issue in the main proceedings.[13]

The kind of proof required is once again left open by the ECJ: Is it the economic possibility, a legal right, or an estimate of the taxpayer that decides this question?[14] By way of handing over the power of determining whether the losses can be used in Sweden to the national court without a guideline for a method how to do that,[15] the national court itself could find its own method, for example, making an economic judgment. The ECJ should at least have given some indication as to how to determine whether losses may still be used in Sweden.

The next delicate question that arose if a cross-border loss transfer is allowed is how the losses should be determined, and according to which law. Since losses do not have a passport to take along wherever they travel, but rather become tax effective under a different tax jurisdiction upon a cross-border transfer, the extent of becoming effective should be determined in accordance with the respective rules of the jurisdiction.[16]

In the *A Oy* case, the ECJ did not explicitly answer the question but gave an indication stating that:

[6] *Cadbury Schweppes plc* (C-196/04), Sept. 12, 2006, para. 51.

[7] *Marks & Spencer PLC v. David Halsey* (C-446/03), Dec. 13, 2005, para. 55.

[8] *Oy AA* (C-231/05), July 18, 2007, para. 67.

[9] *Lidl Belgium* (C-414/16), May 15, 2008, para. 47.

[10] Dötsch and Pung, *Der Konzern* 2006, pp. 130, 133 (abstract); M. Lang, *Steuer und Wirtschaft International* 2006, pp. 3, 9 (actual); Herzig and Wagner, *Deutsches Steuerrecht* 2006, pp. 1, 8 (economic probability).

[11] J. Hey, *GmbH Rundschau* 2006, pp. 113, 115; M. Lang, *Eur'n Tax'n* 2006, pp. 54, 62; Scheunemann, *Internationales Steuerrecht* 2006, pp. 145, 147; *see also* Wimpissinger, *Steuerliche Verlustverrechnung nach EG-Recht* (Peter Lang: Frankfurt am Main, 2006), p. 227.

[12] Herzig and Wagner, *Deutsches Steuerrecht* 2006, pp. 1, 8.

[13] *A Oy*, para. 55.

[14] *See* Wimpissinger, *Verlustverwertung nach EG-Recht* 2006, p. 231.

[15] *A Oy*, para. 54.

[16] *See also* Dötsch and Pung, *Der Konzern* 2006, pp. 130, 134; M. Lang, *Eur'n Tax'n* 2006, pp. 54, 62; Scheunemann, *Internationales Steuerrecht* 2006, pp. 145, 150; Wimpissinger, *Steuerliche Verlustverrechnung nach EG-Recht* (Peter Lang: Frankfurt am Main, 2006), p. 234; this concept is implemented in the Austrian system; *see* section 9(6) No. 6 Corporate Income Tax Act (Körperschaftsteuergesetz) in connection with section 5(1) Income Tax Act (Einkommensteuergesetz).

> the rules for calculating the non-resident subsidiary's losses for the purpose of their being taken over by the resident parent company . . . must not constitute unequal treatment compared with the rules of calculation which would be applicable if the merger were with a resident subsidiary.[17]

Further, the Court stated that this question only needs to be answered if necessary on a case-by-case basis.[18] The Court seems to say that if losses are transferred from one state to another and are used to offset profits in the second state, the losses must be determined in accordance with the laws of the second state. If that was what the Court wanted to say, why did it not say so explicitly? Two reasons come to mind:

- The Court might have believed that the losses should be determined in line with the policy of the respective member state concerning whether it adopted a concept of capital export neutrality or capital import neutrality (CIN). The consequence would be, however, that a country following the territoriality concept by way of implementing the exemption method (achieving CIN) would determine the losses under the concept of the other state. Such concept is not implemented in Austria even though domestic law provides for the transfer of foreign losses in the context of a tax group or a foreign PE. Austrian tax law actually takes a pragmatic (fiscally beneficial) view: The loss determination that results at a smaller amount is decisive, so the loss is determined either under Austrian or foreign law, whichever is more beneficial for the revenue. This cherry-picking method is a discrimination of foreign versus domestic subsidiaries, since the losses of the latter are treated more favorably.
- The ECJ might have believed that the foreign losses should be determined depending on the comparison that led to the conclusion that a violation of the freedom of establishment occurred. Following this rationale, losses may have to be determined under the rules of the state to which they are transferred if the comparison was a purely domestic situation versus a cross-border situation and that a different determination may be considered adequate if one cross-border situation is compared to another cross-border situation.

Because the ECJ explicitly denied a member state's obligation to forgo revenue because of the way another member state imposes taxation in its case law,[19] it is clear that if losses are transferred from one member state to another, it is the rules of the latter that are decisive for determining the losses.[20] Why the Court did not clarify that in *A Oy* remains open.

Interestingly, in rendering her opinion in *A Oy*, the advocate general pointed out that deciding upon a merger has tax consequences that should be considered by taxpayers and explicitly stated that they ''cannot be allowed to choose freely the tax scheme applicable to the losses of a subsidiary.''[21] In the same line of reasoning, the French government suggested offsetting capital gains with the losses instead of opting for a tax-neutral merger, thereby promoting the implementation of a different restructuring, namely a sale of the subsidiary.[22] This is exactly what tax law should not lead to: forcing taxpayers to pursue their business differently than intended only to obtain a better tax result. If the decision to merge a corporate group is considered to freely choose a particular tax scheme, it should be questioned why national laws and the merger directive allow having such transactions be achieved tax neutrally. The statement of the advocate general was surely incomplete, since it would otherwise contradict commonly agreed-upon tax policy.

Proportionality? What Proportionality?

The weak points of the ECJ cross-border travel requirement for losses are obvious: While the ECJ stated that not using foreign losses as soon as in the domestic context results in a cash disadvantage constituting a discrimination,[23] it allowed a later use in the cross-border context because of its proportionality test; not allowing a transfer was considered going too far. The Court concluded that the discrimination arising because foreign losses cannot be used while domestic losses could is justified if the disadvantage relates to foreign losses that might be used when incurred at some later point in time. In other words (and those words make no sense) the cash disadvantage of not using losses is accepted if it only leads to a cash disadvantage. A second, even more striking, weakness of the ECJ's rulings on those questions is that more proportionate ways are known to prevent the fiscal downsides of a cross-border loss utilization, such as double-dips or tax avoidance: a mere clawback (or recapture) rule according to which tax benefits resulting from a cross-border loss transfer that is enjoyed in the period when the loss was incurred are reversed, once the foreign loss

[17] *A Oy*, para. 61.

[18] *Id.* at para. 59.

[19] *Mr. and Mrs. Robert Gilly v. Directeur des Services du Bas-Rhin* (C-336/96), May 12, 1998, para. 48; *see also* Wimpissinger, ''Does Denying Tax Benefits to Income Earned Abroad Violate EU Law?'' *Tax Notes Int'l*, Nov. 25, 2002, p. 809.

[20] Supporting this conclusion: Dötsch and Pung, *Der Konzern* 2006, pp. 130, 134; Herzig and Wagner, *Deutsches Steuerrecht* 2006, pp. 1, 8; J. Hey, *GmbH Rundschau* 2006, pp. 113, 115; M. Lang, *Steuer und Wirtschaft International* 2006, pp. 3, 9; Scheunemann, *Internationales Steuerrecht* 2006, pp. 145, 150.

[21] Opinion of Advocate General Kokott on *A Oy* (C-123/11), July 19, 2012, para. 58.

[22] *A Oy*, para. 53.

[23] *Marks & Spencer PLC v. David Halsey*, para. 32.

is tax effective at the place of its origin.[24] This concept was statutorily provided for under German tax law until 1998[25] and suggested by the European Commission in its proposal for a loss utilization directive.[26] For the case decided on February 21, 2013, this would mean that, yes, the losses are transferred to Finland, but if later used in Sweden, the transfer must be reversed; in the same amount used in Sweden, a profit could be considered to have arisen in Finland (following the Austrian method).

Ironically the ECJ even referred to the loss deduction and recapture concept in one of its follow-up rulings to *Marks & Spencer*,[27] but did not analyze whether it would be a more proportionate measure compared with the concept developed in *Marks & Spencer* and simply stated that the system developed in *Marks & Spencer* according to which only foreign losses that can no longer be used abroad must be allowed as tax effective in the resident state is proportionate.[28] Regarding the distinction of foreign losses established by the ECJ (definitive losses must not be barred from a cross-border transfer, while temporary losses need not be taken into account in order to comply with EU law), note that in its established case law on direct taxation the Court has repeatedly stated that an abstract chance of a tax disadvantage is discriminatory, not requiring an actual negative effect of a specific measure.[29] This is just another reason why the case law regarding transferring foreign losses is questionable as it stands today.

The question why the proportionality of a restrictive measure disallowing the use of foreign losses is fulfilled even though well-established concepts exist in member states' laws is up in the air since the *Marks & Spencer* ruling. Of course the answer is not found in judgments of the ECJ, since it has a political background. Shortly before *Marks & Spencer* was decided, some governments of the member states speculated openly on how to curtail the competences of the ECJ in case it continues to decide cases that reduce their revenue. Not surprisingly the explanation of *Marks & Spencer* was a shock for the tax community and welcomed by some governments. Half a year before the ECJ decided *Marks & Spencer*, another loss case was decided differently. In the *Lindex* case,[30] a Swedish local court reached a striking result deciding on facts similar to the *Marks & Spencer* case that losses of a German subsidiary had been allowed as tax effective at the level of a Swedish parent company in order to comply with EU law. The Swedish court did not consider it necessary to apply for a preliminary ruling request to the ECJ, stating that EU law was clear on that point.

Outcome of *A Oy* and Conclusions

The outcome of the ECJ's ruling in *A Oy* is not spectacular: Foreign losses of a foreign subsidiary that is merged into its parent may only be transferred in accordance with the principles of the *Marks & Spencer* concept. No silver linings for taxpayers. While it is no surprise that the Court did not overrule its own case law, it is disappointing that the ECJ did not use the opportunity to clarify some open issues. Further, it is a negative development that the ECJ handed over a question on the abuse of law to a national court even though EU law is involved.

Another insight from this case is that governments in the EU consider tax law a factor to be taken into account when structuring a business, despite the well-accepted economic principle that tax law should be a neutral factor for businesses. It might be time for the commission to take this up and relaunch an initiative against such views. In a dream world, the loss directive would be proposed again and — this time — implemented. In light of developing a common consolidated corporate tax base (CCCTB) directive, such initiative may not be seen as a first priority, because obviously it would indicate that hopes for a CCCTB are low. ◆

[24]Like this for legions of others: Kessler and Eicke, ''*Lidl Belgium*: Revisiting *Marks & Spencer* on the Branch Level,'' *Tax Notes Int'l*, Mar. 31, 2008, p. 1131.

[25]Former section 2a(3) German Income Tax Act (Einkommensteuerrecht).

[26]Article 7 No. 1(b) of the Proposal for a Council Directive concerning the arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States (COM (90) 595), Dec. 6, 1990 — withdrawn.

[27]*Lidl Belgium*, para. 45; Wimpissinger, *EC Tax Rev.* 2008/4, p. 179.

[28]*Lidl Belgium*, paras. 45 (regarding the loss recapture concept), 47.

[29]Wimpissinger, *Steuerliche Verlustverrechnung nach EG-Recht* 2006, p. 56; *see also* Vanistendael, *EC Tax Rev.* 2008, p. 52, 60.

[30]Ländsrätteni Vänersborg (local Swedish administrative court), May 30, 2005, 8 *ILTR* 2005, p. 8.