# CROSS-BORDER LOSS RELIEF: THE PORTUGUESE RULES AND THE CASE FOR HARMONISATION[1]

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## The *Metallgesellschaft* decision

The *Metallgesellschaft*[3] judgment concerned the obligation imposed on companies resident in the UK to pay advance corporation tax with respect to dividends paid to their parent companies. In this case there were several subsidiaries resident in the United Kingdom distributing dividends to their parent companies resident in Germany. According to UK rules at the time (section 247 ICTA) two companies resident in the UK, one of which holds at least 51% of the other, may make a group income election. This group income election resulted among other things in the possibility of the subsidiary not paying ACT on the dividends which it paid to its parent company.

Non-resident companies were not allowed to make a group income election which was only for UK resident companies. The German parent companies considered that this difference in treatment amounted to unjustified discrimination between parent companies resident in different Member-States contrary to the EC Treaty, because it was impossible for non-UK residents and their UK subsidiaries to make a group income election which would have enabled the subsidiaries to avoid payment of ACT.

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1 This article follows on from an analysis of cross-border relief given in The EC Tax Journal, Volume 10, Issue 1, page 27.

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3 [2001] STC 452

Notwithstanding the fact that the ACT paid by subsidiaries resident in the UK could later be deducted against the mainstream corporation tax the possibility of making a group income election constituted a cash-flow disadvantage which subsidiaries of parent companies resident in the UK did not incur. This cash-flow disadvantage comes from the fact that in a purely domestic situation subsidiaries were able to retain, until the date when the mainstream corporation tax was due, the sums which they would otherwise have to pay as ACT on the distribution of dividends to their parent companies.

The ECJ concluded with their concerns on this issue as follows:

> *"to afford resident subsidiaries of non-resident companies the possibility of making a group income election would do no more than allow them to retain the sums which would otherwise be payable by way of ACT until such time as MCT falls due. They would thus enjoy the same cash flow advantage as resident subsidiaries of resident parent companies (... )* ***the difference in the tax treatment of parent companies depending on whether or not they are resident cannot justify denial of a tax advantage to subsidiaries, resident in the United Kingdom, of parent companies having their seat in another Member State where that advantage is available to subsidiaries, resident in the United Kingdom, of parent companies also resident in the United Kingdom****, since all those subsidiaries are liable to MCT on their profits irrespective of the place of residence of their parent companies"*[4].

Also, with regard to justification:

> *"the refusal to allow subsidiaries, resident in the United Kingdom, of parent companies resident in another Member State to make a group income election cannot be justified on grounds relating to the need to preserve the cohesion of the United Kingdom's tax system"*[5].

Therefore, the Court found the different treatment of a purely domestic situation and a cross-border situation consisting of a cash-flow advantage given to the purely domestic situation contrary to Article 52 of the EC Treaty mainly because non-resident parent companies could not make a group income election.

The parallel with the Portuguese situation on cross-border loss relief is immediately identifiable. Because a non-resident company is not allowed to make a group income election with a Portuguese resident company a purely domestic situation is being given a cash-flow advantage consisting on the possibility of immediately deducting their losses on profits earned by their group company.

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4 Paragraph 54.

5 Paragraph 73.

Thus, the cross-border situation is disadvantaged in comparison to a purely Portuguese situation because the latter will be able pay less tax immediately while the former will have to wait until the company sustaining the losses is profitable in order to deduct the losses accumulated.

**Justification**

After laying down the existence of a restriction to freedom of establishment it is necessary to analyze that restriction to determine whether the Portuguese domestic rules can be considered justified by imperative reasons in the public interest and, if that is the case, whether the Portuguese domestic rules are proportional.

The requirements to consider whether the domestic rules are justified come from the jurisprudence in *Gebhard*[6] and *Kraus*[7]*:* (i) the application of the rule in a non-discriminatory way; (ii) the need to meet a general public interest; (iii) to be adequate and necessary to attain its purpose; and (iv) it cannot go beyond what is necessary to attain the said purpose.

With regard to the first requirement in the analysis above it is my contention that the different treatment given to a purely domestic situation and a cross border situation (migrant/non-migrant) was not discriminatory. This conclusion was made on the basis that the two situations are not in a comparable position because the foreign subsidiary is not subject to tax in Portugal on its business profits. Thus, I can safely assume the Portuguese domestic rules denying the possibility of cross-border loss relief are not applied in a discriminatory way because they treat different situations differently in tune with the jurisprudence established in the *Schumacker*[8] judgment.

To check the remaining requirements, of the *Gebhard* jurisprudence, the relevant justification to these types of rules would be the balance achieved by the allocation of taxing rights between Portugal and other Member-States concerning the taxation of profits. As shown above allowing the cross-border loss relief from foreign subsidiaries would jeopardize Portugal's tax sovereignty because it would mean Portugal was waiving its taxing rights on business profits of companies residing in Portugal.

Also, by allowing the cross-border loss relief Portugal would be opening the doors to a great tax avoidance opportunity. Portugal has one of the highest corporate tax

6 Case C-55/94 [1995] ECR I-4165

7 Case C-1992 *Kraus v Baden-Wuerttemberg* [1993] ECR I-1663

8 Case C-279/93 *Finanzamt Koln-Altstadt v Roland Schumacker* [1995] ECR I-00225

rates in the EU, especially after the joining of the new members. Because of this fact companies would try to shift the taxation of profits to lower tax jurisdictions in the EU and save a significant amount of tax by transferring the losses to Portugal. This possibility makes the cross-border loss relief a very difficult system to implement in the EU without some form of harmonization between the Member-States.

The third argument of the justification used in *Marks & Spencer*[9] was the possibility of double deduction of losses. In the transfer of losses between companies from one Member-State to the other opportunities could arise where the losses would be used twice, once in the host state and another in the origin state. Notwithstanding the fact this could happen, I believe as said above that the instruments in place in the EU, specifically the mutual assistance in the recovery of tax directives, allow Member-States to combat this possibility by asking the Member-State involved for information which would allow them to control the double dipping possibility.

In *Marks & Spencer* the Court did not agree with this view and consider this risk to be relevant in the analysis of the justification accepting it as an argument to maintain the UK domestic rules. Nevertheless, the Court has already accepted this justification in *Lidl Belgium*[10] using only two of the three arguments.

The conclusion is that the ECJ will accept domestic rules on cross-border loss relief that can be justified by two of the three arguments presented in *Marks & Spencer*, and also believes that rules disallowing the possibility of offsetting cross-border loss relief are adequate to attain the purpose of avoiding disrupting the balanced allocation of taxing rights and the risk of tax avoidance which would arise.

## Proportionality

Finally, it is necessary to determine if the Portuguese domestic rules are in any way disproportionate. In order to assess the requirements established in *Marks & Spencer* and confirmed in *Oy AA*[11] and *Lidl Belgium* are fulfilled. The ECJ described two situations where the cross border loss relief must be allowed in order for the domestic rules to be considered proportional.[12]

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9 Case C-446/03 *Marks & Spencer plc v Commissioners of Custom and Excise* [ECR I-10837]

10 Case C-414/06 *Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn* [2008] ECR I-03601 Paragraph 42.

11 C-231/05 [2007] ECR I-06373

12 As we said above in our analysis of Marks & Spencer the two situations are "- *the non-resident subsidiary has exhausted the possibilities available in its State of residence of having the losses taken into account for the accounting period concerned by the claim for relief and also for previous accounting periods, if necessary by transferring those losses to a third party*

By establishing these two requirements the ECJ clearly stated that loss relief regimes that do not allow the cross-border loss relief in situations where the possibilities of offsetting the losses in the state of residence have been exhausted do not pass the proportionality test and fail to fulfill the last requirement established in the *Kraus* and *Gebhard* judgment.

**Conclusion**

Looking at the Portuguese domestic rules analyzed above it is clear that the Portuguese domestic rules do not allow the cross-border loss relief using the group income election, even in situations where the foreign subsidiary has exhausted all possibilities of deducting the losses in their residence state. This includes situations where the time limit for loss relief is surpassed and also situations where the companies has sold its facilities or ceased trading. The Portuguese domestic rules exclude without exception all possibilities of a foreign subsidiary becoming part of group income election because only the special regime can only apply to Portuguese resident companies.

The conclusion is also fairly simple: the Portuguese domestic rules are not proportional according to the ECJ jurisprudence in the area of cross-border loss relief and should be changed in order to become compatible with freedom of establishment and the ECT.

**Possible solutions to the present incompatibility**

In dealing with the incompatibility found in the Portuguese domestic rules on loss relief several solutions can be applied. The first, and more obvious solution, would be to end the special group income election regime. By ending the regime Portugal would be ending the disadvantage given to cross-border situations. However, this solution brings two problems. The first is that Portugal would still have to amend possible situations which had already occurred when the regime was in place. The second problem is Portugal would be ending the regime for the wrong reasons; the Portuguese economic groups would see their present situation disadvantaged only so the benefit would not extend to cross border subsidiaries in final losses scenarios.

Also, this does not seem to be the way in which the EU wants to evolve. In December 2006, the European Commission released a communication to the Council, the European Parliament and the European Economic and Social

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*or by offsetting the losses against the profits made by the subsidiary in previous periods, and (…) - there is no possibility for the foreign subsidiary's losses to be taken into account in its State of residence for future periods either by the subsidiary itself or by a third party, in particular where the subsidiary has been sold to that third party*". (paragraph 55).

Committee on the Tax Treatment of Losses in Cross-Border Situations[13]. In this communication the Commission stressed that allowing cross-border relief is one step further toward achieving the Lisbon Strategy and suggests three possible ways in which Member-States could change their domestic rules in order to allow the cross-border loss relief.

An alternative is the definitive loss transfer or intra-group loss transfer which would allow a definitive transfer of losses within a domestic group income election scheme without any posterior recapture of future profits. This solution implies the Member-State of the company absorbing the losses will lose tax revenue which would otherwise tax if the cross-border loss relief was not granted. To avoid the loss of tax revenue the Commission suggests a clearing system where the Member-State of the company absorbing the loss would be compensated by the Member-State of the company surrendering the loss if a company was systematically offsetting losses from one Member-State to the other.

This solution is questionable not only because it would require harmonization between Member-States in an area in which Member-States are still not prepared to bring harmonization, but 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 alternative suggested by the Commission was the temporary loss transfer or deduction and recapture method[14]. According to this solution a loss suffered by a subsidiary in one Member-State could be deducted from the results of a parent company resident of another Member-State but would subsequently be recaptured in future years as soon as the subsidiary makes profits. The recapture of the losses would be done by a corresponding additional tax burden at the level of the parent company which would have to pay the tax it avoided paying when the losses suffered by the subsidiary were immediately offset in the results of the its parent company.

This mechanism would avoid the cash flow disadvantage seen in *Lidl Belgium* in situations involving subsidiaries, because by allowing immediate temporary relief for the cross-border losses companies would not have to wait for the subsidiaries to become profitable in order to offset the losses. The results of the whole economic group would be considered and taken in to account. This solution was the approach

13 COM (2006) 824 final {SEC(2006) 1690}.

14 This was also the method which was in place in Germany until 1990 and which Advocate General Sharpston used to try to demonstrate German domestic rules could foresee less restrictive measures and therefore were not proportional according to the Gebhard jurisprudence. This alternative has the advantage to be relatively easy to operate and implement.

chosen by the Commission in their proposal for a Directive in this area submitted in 1990 but which was not brought forward by Member-States.

The third alternative was current taxation of subsidiary's results or system of consolidated profits. The main idea behind this solution is to apply the credit system instead of the exemption system to subsidiaries and treat them as if they were PEs.

Thus, as in a situation between a head office and its PE, parent and subsidiaries would have consolidated results which meant profits and losses for a given tax year of the group (subsidiary and parent company) are taken into account at the level of the parent company. To avoid the double taxation the Member-State would apply the credit method which would allow the subsidiary to deduct from the tax payable in the Member-State of the parent company the tax already paid in the Member-State of the subsidiary with regards to the latter's income. Also, profit distributions between the group members would not be taken into account for taxing purposes.

This solution would obviously solve the cross-border loss relief problem which would immediately be taken into consideration at the level of the parent company and was intended to work as a voluntary regime in which companies would elect to participate for a certain period in the same way the present Portuguese group income election special regime.

The Commission suggests two different schemes in this system of consolidated profits: a selective scheme where groups could choose which companies would form the group or a comprehensive scheme where if the group chose to be taxed according to this regime all subsidiaries of the group had to be elected.

In our opinion, the main problem with this solution is that it constitutes a deviation to article 7 of the OECD model. According to the allocation of taxing rights in article 7 the business profits of foreign subsidiaries can only be taxed in the State of residence of the subsidiary. However, this problem can be overcome by making it an elective and voluntary scheme. However, there is still doubt whether final losses of companies which chose not to elect the scheme and, thus, could not offset the losses would still constitute a restriction on freedom of establishment.

Other problems with this option include the large compliance costs with documentation because groups would have to recalculate the income of the group members under the rules of two different sets of rules, the Member-State of the parent company and the Member-State of the subsidiary. Also, this regime would be vulnerable to aggressive tax planning techniques involving concentrating cost in subsidiaries chosen for consolidation.[15]

I would suggest another solution: to change the Portuguese domestic rules in order to accommodate the decision of the Court in *Marks & Spencer*. This could be done by changing article 63 of the CIRC to allow subsidiaries with final losses to enter the group and offset their losses at the level of the parent company. However, this solution would require further study to find a way to accommodate the *Marks & Spencer* decision without making the Portuguese regime incoherent. Also, this solution would not allow Portugal to recapture future profits of the subsidiary in situations where the subsidiary had ceased trading which would mean Portugal would be effectively waiving taxing rights on profits of a resident parent company.

This is similar to the balance attained regarding freedom of workers. As demonstrated above the present Portuguese domestic rules do not respect this balance and do not permit a final loss to be offset from a Portuguese parent company in a group income election. This balance obliges Portugal to accept a final loss coming from a foreign subsidiary of a Portuguese resident parent company.

An example of this is a Portuguese company with a subsidiary in the UK where the latter ceased trading because of the lack of clients. If the subsidiary has exhausted the possibilities to deduction the losses and does not have any other company of the group in UK to deduct them against it will be allowed according to this balance to offset the losses at the level of the Portuguese parent company through a group income election regime.

With regard to possible solutions to the present incompatibility of Portuguese domestic rules, although it may be the simplest solution, ending the group income election regime to avoid foreign subsidiaries from deducting final losses in Portuguese resident parent companies is a step in the wrong direction, i.e. it does not further the Lisbon agenda which laid down the future objectives of the EU.

If the EU wants to become the most powerful economy in the world it must continue to push forward in the area of direct taxation and support the harmonization of the rules between Member-States and in this way attract economic groups to the EU. A cross-border loss relief system would be a step in the right direction. However, because harmonization in the area of direct taxation still does not exist, Portugal is

15 This regime would be something similar to the check-the-box regime adopted by the USA. This regime allows a foreign entity taxed as corporation or as transparent for US tax purposes. For more information on this regime see Jesper Barenfeld book "*Taxation of Cross-Border Partnerships: Double Tax Relief in Hybrid and Reverse Hybrid Situations*" - Doctoral Series: Vol. 9.

not obliged to introduce rules which require harmonization to survive.[16]

Also, the role of the ECJ is to by its judgments exercise negative integration. This means the Court is only allowed to decide on the compatibility of the Member-States domestic rules with the freedoms and the ECJ and cannot force Member-States to introduce provisions into their domestic laws.

The introduction of new rules or harmonized rules by way of positive integration is a role reserved for the Commission and other organs of the EU. However, the fact that the Commission has not proposed any harmonization rules in this area does not mean Member-States can disregards the effects an ECJ judgment has on the rules of all Member-States. In the *AMID*[17], *Marks & Spencer* and *Lidl Belgium* judgments the Court defined the requisites which Member-States' domestic rules must fulfill to be compatible with freedom of establishment.

In conclusion, although Portugal is not obliged to introduce rules which would allow the cross-border loss relief of temporary losses it will have to choose one of the solutions proposed above in order to allow final losses of foreign subsidiaries to be offset at the level of the Portuguese resident company. Otherwise every company in a situation of final losses can make its right prevail in Court.

16 The Court stated this in the *Marks & Spencer* judgment when it said: "*Furthermore, in so far as it may be possible to identify other, less restrictive measures, such measures in any event require harmonisation rules adopted by the Community legislature*". (paragraph 58).

17 C-141/99 *Algemene Maatschappij voor Investering en Dienstverlening NV (AMID) v Belgische Staat* [2000] ECR I-11619