Tax treatment of losses in cross-border situations

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PURPOSE: to report on the tax treatment of losses in cross-border situations.

CONTENT: the Commission has prepared this report within the context of coordinating Member States' direct tax system in the Internal Market. The specific purpose of this report is to explain the basic principles and problems regarding cross-border loss relief and to suggest ways in which the Member Stats can consider allowing cross-border relief of losses.

The issue of tax losses in cross-border situations: Virtually all tax systems within the EU treat profits and losses asymmetrically. Profits are taxed for the tax year in which they are earned but the tax value of a loss is not refunded when the loss is incurred. In order not to become "over-taxed" companies will therefore typically set losses off against another positive tax base within the company or within a group of companies. In this way they avoid cash-flow disadvantages that result from the time lag for setting off the loss. A company with several domestic branch operations will, in principle, be automatically taxed on the net result. In most other situations, relief for losses is possible only when authorised by a specific provision adopted by the respective Member States.

The internal market and the impact on business decisions: Varying national rules on cross-border losses by the Member States impact on the functioning of the internal market. The lack of cross-border loss relief creates a barrier to entering other markets, which in turn perpetuates the artificial segmentation of the internal market along national lines. Due to economies of scale, companies in large Member States have an advantage over potential competitors from smaller Member States – even where the latter are more innovative and efficient. Thus, the lack (or limited) availability of cross-border loss relief, favours domestic investments and acts as a disincentive to investments in other Member States; favours cross-border investment in larger Member States; favours large companies to the disadvantage of SME's; and influences the choice between a permanent establishment and a subsidiary as a form of establishment.

Losses within one company – the issue of losses incurred by permanent establishments: When it comes to the issue of losses incurred by permanent establishments, the report notes that this could, potentially, hinder companies from establishing themselves outside of the country in which they are established. For example, where losses incurred by permanent establishments may not be set off against profits of a head office (vertical upward set-off), there will be a difference in treatment when compared to a purely domestic situation. This makes it less attractive to exercise freedom of establishment and a company may refrain from setting up a permanent establishment in another Member States. Indeed, the ECJ explicitly states, in the AMID case, that a company with a permanent establishment abroad is in a comparable situation to that of a company who is not.

Losses within a group of companies – the issue of losses incurred by foreign subsidiaries: Groups of companies do not have legal personality under corporate law, nor is such a group recognised as a single taxable entity in its own right. With a group of companies, therefore, losses are not taken into account automatically in the way there are within a single company. However, a number of Member States have introduced a domestic system for group taxation in order to treat a group as a single economic unit, though only a limited, albeit increasing number of Member States, have loss relief systems that also apply to cross-border situations. This lack of a domestic group taxation scheme can also distort investment decisions regarding the legal form of the investment and favour the establishment of a branch rather than a subsidiary.

Alternatives for cross-border loss relief: In theory there are three possible alternatives which provide for such a minimum level of loss compensation. These alternatives do not differ when losses are taken into account but do differ with regard to their treatment of future profits of subsidiary at the level of the parent company. The three alternatives are:

I. **definitive loss transfer (inter-group loss transfer):** This scheme would lead to a definitive transfer of losses or profits without recapture, unless counterbalancing measures have been introduced. One way of neutralising the effect on the revenue of the Member States, in which a loss-absorbing company is resident, would be to introduce a clearing system so that the Member State of the company surrendering the loss would compensate the Member State of the company absorbing the loss. The system would need to take account of any significant differences between applicable tax rates and tax accounting rules. Special attention would also have to be given to tax planning issues.

II. **temporary loss transfer (deduction /reintegration method):** Under this scheme a loss incurred by a subsidiary situated in another Member State and which was deducted from the results of the parent company, is subsequently recaptures once the subsidiary returns to profitability. This results in temporary transfer of losses. This was the approach chosen in the 1990 proposal for a Directive. The advantage of this method is that it is relatively easy to operate.

III. **current taxation of subsidiary's results (system of consolidated profits):** Under this system, the profits and losses for a given tax year of selected, or all group members, are taken into account over a certain time period at the level of the parent company. Consolidated subsidiaries would be treated in the same manner as permanent establishments. The credit method would be applied to eliminate double taxation. Tax paid by a subsidiary in its State of residence would be credited against the tax payable in the Member State of the parent company in respect of income from the subsidiary. Profit distribution between the group members would not be taken into account. The application of such a scheme is not linked or limited to the existence of losses. Therefore, once a subsidiary has been elected to participate in such a scheme, it will normally be applied for a certain period for time. A system of consolidated profits could consist of either a selective scheme or a comprehensive scheme.

Conclusion: In its conclusion, the Commission stresses the need for an effective cross-border loss relief scheme within the EU. The limited availability of cross-border loss relief is one of the most significant obstacles to cross-border business activity. Those who will most benefit from such a scheme are SME's', who currently suffer from the lack of such relief.

Thus, where Member States do not allow losses incurred by permanent establishment in other Member States to be taken into account, the Commission strongly encourages these Member States to review their tax systems in order to promote the freedom of establishment provided by the EU Treaty. The Commission also strongly encourages Member States to introduce and maintain domestic tax systems for loss relief within a group of companies that offer treatment equivalent to that provided for loss relief within a single company. This would eliminate distortions and enhance the attractiveness of the country in question as an investment location. Finally, the Commission stresses the need to make cross-border loss relief within a group of companies more widely available, for the development of businesses across the single market and world wide.

Three possible approaches are being offered for cross-border loss relief. The response should be co-ordinated in order to maximise the benefits for the internal market and in order to reduce any unnecessary

duplication of effort within the 27 EU Member States. The Commission, therefore, invites the Council, European Parliament to examine the proposals set out in this Communication with a view to urging the Member States to:

- review existing national systems to provide relief for losses within a company in cross-border situations;

- rapidly implement one or more of the possible solutions presented in this Communication for the treatment of losses incurred within groups of companies; and

- consider how the suggestions set out in this Communication can be applied to both domestic and cross-border situations by improving existing loss relief schemes and by introducing new ones.