Jürgen Lüdicke,* Jürg B. Altorfer,** Gauthier Blanluet,*** Daniela Hohenwarter-Mayr,**** Koichi Inoue,***** Steve Suarez,****** and Carolin Lange-Hückstädt*******

Cross-Border Loss Utilization

This article summarizes the panel proceedings of Seminar C of the 67th Congress of the International Fiscal Association (IFA) held in Copenhagen on 26 August 2013. Seminar C considered different aspects of cross-border loss utilization, including systematic and policy considerations, possibilities and limitations, and anti-avoidance measures.

1. Introduction and Outline of the Discussion

The topic of Seminar C of the 2013 Congress of the International Fiscal Association (IFA) was "Cross-border loss utilisation". The panel revisited the systematic background and potential for cross-border loss utilization, including tax planning ideas. Other issues discussed were tax policy considerations and the potential influence of the Base Erosion and Profit Shifting ("BEPS") project of the OECD.

The topic "cross-border loss utilization" is not new. It was covered by Subject II of the 1979 Copenhagen Congress[1] and has been touched upon in several of the Subjects and Seminars of subsequent IFA Congresses since then.[2] In spite of this repeated preoccupation, the topic still has many unexamined facets that called for another IFA Congress discussion.

Internationally operating enterprises are generally – but especially in times of crises – interested in offsetting losses of the enterprise or the group against taxable profits at the same time or at least soon after the losses were incurred. The lack of possibilities for loss-offsetting not only leads to cash-flow disadvantages but might also negatively affect the group tax rate. However, due to the sometimes extremely high loss carry-overs in certain countries, governments – particularly in the light of current austerity programmes and budgetary constraints – are often interested in limiting loss utilization in general. This applies all the more for cross-border loss utilization, i.e. the deduction of losses incurred outside the taxpayer's own taxing jurisdiction. On the other hand, the permissibility of cross-border loss utilization does not necessarily lead to tax deficits only but may also – at least to a certain extent – promote a country's economy by attracting new business. In an EU context, in certain constellations, EU law might require the possibility of cross-border loss utilization.

The panel session started with remarks about the scope of the Seminar and some definitions (*see* section 2.), followed by a few basic systematic and policy considerations (*see* section 3.). On that basis, a closer look was taken at the possibilities and limitations regarding cross-border loss utilization (*see* section 4.). Despite the already existing limitations, many countries have been focusing on additional anti-avoidance measures for a long time. This aspect was touched upon by the panel (*see* section 5.) before examining possibilities for businesses to react to these limitations by using tax planning strategies (*see* section 6.). In their final observations, the panelists brought up the current BEPS discussion and summarized the results and views expressed by the panel (*see* section 7.).

2. Scope and Definitions

For the purposes of the Seminar, the scope of cross-border loss utilization was narrowed down to *foreign corporate losses* (including those received/attributed through a tax transparent partnership), with the term "foreign losses" being defined as negative income from other tax jurisdictions.

The panel looked at the reduction of the tax burden of companies that lower their tax base through offsetting losses against taxable income. Consequently, neither individual deductions and expense allocation issues (i.e. transfer pricing questions) nor currency losses were dealt with.[3]

The types of losses addressed were further classified into "own losses" and "losses of other entities". Not only that the tax treatment of those two types of losses often differs

* Partner, PricewaterhouseCoopers, Hamburg, and Professor at the University of Hamburg. The author can be contacted at Juergen.Luedicke@de.pwc.com.

** Advisor for company taxation, member of the management at the cantonal tax authority, Zürich, Switzerland and lecturer in two Master of Laws in taxation programmes and many tax seminars. The author can be contacted at Juerg.Altorfer@ksta.zh.ch.

*** Partner, Sullivan & Cromwell LLP, Paris, and Professor at the University of Paris II. The author can be contacted at BlanluetG@sullcrom.com.

**** Senior research associate at the Institute for Austrian and International Tax Law of the Vienna University of Economics and Business (WU). The author can be contacted at Daniela.Hohenwarter-Mayr@wu.ac.at.

***** Partner, Jones Day, Tokyo, and lecturer at various universities. The author can be contacted at kinoue@JonesDay.com.

****** Partner, Borden Ladner Gervais LLP, Toronto, and Councillor of the Canadian IFA branch. The author can be contacted at SSuarez@blg.com.

******* Manager, PricewaterhouseCoopers, Hamburg. The author can be contacted at Carolin.Lange-Hueckstaedt@de.pwc.com.

1. *See* IFA, *The Effect of Losses in One Country on the Income Tax Treatment in Other Countries of an Enterprise or of Associated Companies Engaged in International Activities, Cahiers de droit fiscal international*, vol. 64b (Kluwer 1979).
2. For example, Subject I "Tax treatment of corporate losses" at the 1998 IFA Congress in London; Seminar B "Tax treatment of currency profits and losses" at the 2000 IFA Congress in Munich (*see* P. Pistone & C. Romano, *Short Report on the Proceedings of the 54th IFA Congress, Munich 2000*, 55 Bull. Intl. Fiscal Docn. 1 (2001), Journals IBFD); with respect to controlled foreign companies (CFCs) – discussions at the 2001 IFA Congress in San Francisco and the 2009 IFA Congress in Vancouver; and Seminar B "Cross-border arbitrage" at the 2012 IFA Congress in Boston.
3. These topics were already covered, at least to a certain extent, at previous IFA Congresses, for example, Munich 2000 and Vancouver 2009.

under domestic law, but this distinction also regularly has an impact on the calculation of foreign tax credits in tax treaty situations. And most notably: the distinction between "own losses" and "losses of other entities" is very helpful to explain the basic principles of losses and their utilization in international cases.

The term "own losses" refers to the negative income attributable to a foreign permanent establishment (PE) or a foreign tax transparent partnership which is treated like a foreign PE. Another prominent example of an "own loss" is the loss produced by foreign real estate. The common feature of all these losses is that they are reflected in the taxpayer's own tax balance sheet or profit and loss accounts in the residence state provided this state taxes income on a worldwide basis.

The counterpart of "own losses" are "losses from other entities" as cross-border loss utilization may also be achieved interpersonally, i.e. in situations where a taxpayer resident in one state is allowed to use the original losses of another – legally independent – taxpayer that is resident in another state for tax purposes. Here, the main question of interest touched upon by the panel was the applicability of cross-border group taxation regimes.[4] Furthermore, the use of hybrid entities can lead to interesting results (*see* section 5.3.).

Based on the criterion of balance sheet or income statement presentation, losses related to shares in foreign group companies are considered "own" losses. This is true for current value write-downs, capital losses realized upon the alienation of shares and liquidation losses. However, it should be noted that these losses might be of dual nature: if one refers to the cause of the decline in value, the above-mentioned losses may also be classified as "another entity's losses". This is the case when the decline can be traced back to losses suffered by the foreign group company itself. Consequently, only decreases in value that are not linked to actual/original losses in the subsidiary (for example, due to unfulfilled profit expectations) could be regarded as "real" own losses.

3. Systematic and Policy Considerations

The starting point of any systematic considerations should be the goal that no more than the total income generated between the setting up and liquidation of an enterprise should be taxed. This "principle of total income" has some key features.

The sum of income taxable in all tax periods together should not exceed the total lifetime earnings. In its pure form, this principle depends neither on the corporate structure nor on the fact as to whether the business is conducted domestically or across borders. The sequence of profits and losses and profit allocation methods should not matter either.

However, this principle is not always fully implemented in tax laws. For instance, taxation on an annual basis is very common because states need tax periods in order to obtain regular and foreseeable tax revenues. Practical and fiscal reasons can lead to legal limitations, like a maximum period for carry-overs of losses or start-up expenses. Other restrictions with respect to loss carry-forwards can be related to the kind of activities within one enterprise. Additionally, changes in the structure or circumstances of the enterprise (for example, cross-border relocations, cross-border business restructurings/reorganizations or changes of business activities) can lead to a breach of the principle of total income as more emphasis is placed on other systematic considerations, such as the principle of territoriality, the taxpayer principle (i.e. that each taxable person is subject to tax only on its own income) or the substance-over-form approach.

In addition to systematic considerations, the panel also pointed out other aspects of tax policy, such as changes in the internal or external political environment of a country and the need for smaller economies to make their taxation regimes more competitive and hence more attractive.

Within the European Union, tax policy is shaped by the fundamental freedoms laid down in the Treaty on the Functioning of the European Union (TFEU),[5] as interpreted by the decisions of the Court of Justice of the European Union (ECJ). Hence, the ECJ judgments can be an important factor for Member States in designing their loss utilization regimes. Restrictions on the freedom of establishment resulting from unequal tax treatment are, in principle, prohibited and can only be justified under certain circumstances. Nevertheless, summarizing the case law of the ECJ, the freedom of establishment only provides for a minimum standard of cross-border loss utilization.

Furthermore, the lack of, or limitations on, cross-border loss relief may lead to an artificial segmentation of the internal market. This has also been acknowledged by the European Commission. In various approaches and initiatives, it has tried to tackle the problem by positive integration,[6] so far without resounding success. Nevertheless, the Commission's general tax policy and specific suggestions may influence the Member States' respective lines of action.

Based on these policy considerations, the panel looked into possibilities for cross-border loss utilization when international activities of a company or a group of companies result in losses in one or more countries and profits in others.

4. Possibilities and Limitations

4.1. "Own" losses – PE case

The starting point for the panel's discussion on the possibilities and limitations of cross-border loss utilization was the treatment of the taxpayer's own losses in a PE scenario illustrated by Example 1 (*see* Diagram 1).

4. For example, in Austria or Denmark.

5. Treaty on the Functioning of the European Union (TFEU) (consolidated version), OJ C83 (2010), EU Law IBFD.

6. *See* section 7.

Diagram 1: Results of the application of the different methods to avoid double taxation

		Year 1		Year 2		Total		
P/L	PE	+100		–100		+/– 0		
	HO	+100		+100		+200		
Exemption								
Tax	PE		30		0		30	90
	HO		30		30		60	
Exemption with claw-back								
Tax	PE		30		0		30	60
	HO		30		0		30	
Credit								
Tax	PE		30		0		30	60
	HO		30		0		30	

ACo carries out business through its head office (HO) and a foreign PE. The tax rates are 30% in both the HO state and the PE state. The PE state's tax laws provide for a loss carry-forward, but they do not provide for any loss carry-back. A period of two years is considered. HO makes a profit of 100 in both years. The PE makes a profit of 100 in year 1 and suffers a loss of 100 in year 2.

As a first step, the different effects of the methods to avoid double taxation (i.e. the credit method, the simple exemption method and the exemption with temporary loss-deduction and claw-back) were examined.

In year 1, there is a tax of 30 due in the PE state. The loss of year 2 cannot be offset against the profit of year 1 as there is no loss carry-back available in the PE state.

In the HO state, the tax in year 1 is always 30, regardless of the applied method. All methods avoid international double taxation. The well-known principles of capital import or capital export neutrality are of no relevance as the tax rates are the same in both countries.

The most important difference in the application of the methods can be seen in year 2. Under the credit method, the PE loss is offset against the HO profit and no tax is due in the HO state. The same applies if the HO state applies the exemption with claw-back method. Looking only at years 1 and 2, the total tax in both countries amounts to 60, which seems to be quite appropriate given the total income of 200. Whether or not the offsetting of the PE loss has a temporary or a permanent effect depends on the future development of the PE results.

Only under a simple exemption method, the PE loss of 100 is disregarded and the HO profit of 100 triggers a tax of 30. The tax on the company's total income of 200 in both years amounts to a total of 90 for the two states. The result seems to be acceptable for HO states with a territorial system, like France. However, a total tax of 90 is also due in states which apply the principle of worldwide income taxation but use the simple exemption method in their tax treaties (for example, Germany).

In the discussion following the analysis of the example, it was stated that under the exemption method, the tax of 30 due by the PE may be recovered if the PE state applied a carry-back system. As a result, the total tax would be 60 under both the exemption and exemption with claw-back methods. This raised the question of whether it is really the HO state's responsibility to counterbalance such legal shortcomings of the PE state. On the other hand, it was also mentioned that the imputation of ordinary losses is usually mainly a timing issue. Therefore, such losses should be deductible in the home country, subject to a recapture rule.

Finally, this case was also reviewed from an EU perspective. Referring to the ECJ decision in a similar case (*Lidl Belgium*, Case C-414/06),[7] it was again pointed out that not even EU law as it stands now requires the in-phase deduction of foreign losses but instead only when they become final or definitive.

4.2. Losses of a foreign subsidiary

When it comes to losses of foreign subsidiaries, two approaches should be strictly distinguished. Firstly, a profitable parent company may seek to offset the foreign group company's losses against its own profits. Secondly, losses of a foreign subsidiary may cause a current value write-down at the parent level or, at a later point in time, these losses may lead to a capital loss upon alienation of the shares or liquidation of the subsidiary. This might be called an indirect utilization of the losses. As there are two layers of taxpayers, there may be two layers of losses. It could, therefore, be argued that the parent company tries to use

7. DE: ECJ, 15 May 2008, Case C-414/06, *Lidl Belgium GmbH & Co. KG v. Finanzamt Heilbronn*, ECJ Case Law IBFD.

its own loss, as it does in the case of "own" losses generated by a PE (*see* section 4.1.).

The panel illustrated this issue with the following example:

Parent-Co sets up a foreign SubCo with equity of 10 million. Subsequently, SubCo suffers a loss of 9 million. Based on the assumption that there are no further hidden reserves, three alternatives were discussed:

– Alternative 1: ParentCo makes a current value write-down in its books to 1 million.

– Alternative 2: SubCo is liquidated and as a result Parent-Co receives 1 million.

– Alternative 3: The shares in SubCo are sold for 1 million.

Although in all three alternatives, ParentCo will suffer an own loss of 9 million, the following questions arise:
– should ParentCo be able to deduct the loss in all three alternatives; and
– does it make a difference whether SubCo's loss carry-forward remains?

In its ensuing discussion, the panel made clear that a direct utilization of the losses of foreign group companies is an extremely rare feature of tax systems. However, foreign subsidiaries' losses may, depending on the facts and circumstances, result in current value write-downs or capital losses at the level of the parent company. Such write-downs or capital losses are sometimes tax effective, but quite often they are not, due to a participation exemption or similar rules.

From a policy point of view, one may well debate whether or not the application of a participation exemption to ParentCo's own loss is appropriate in each of the three alternatives. The issue is similar to the exemption of foreign PE losses under the exemption method in tax treaties. If the purpose of both exemptions is to avoid juridical or economic double taxation, it seems fair to state that, in the case of losses, no such double taxation exists.

Apart from that, a current loss of SubCo does not necessarily lead to a respective write-down or capital loss at the ParentCo level. The loss of SubCo may, for instance, be caused by investments which do not at all diminish the value of the company. Additionally, if the market value of the shares is higher than their book value at the ParentCo level, a current loss of SubCo would not necessitate a current value write-down.

On the other hand, there are cases where a current value write-down or a capital loss has not at all been caused by losses of a subsidiary but simply by profit expectations which it failed to meet. Hence, from a systematic point of view, when selling shares of SubCo or in the case of liquidation of SubCo at the latest, the amount of depreciation not covered by retained earnings, including hidden reserves, would be a real loss for ParentCo that should be tax deductible.

For all these reasons, it is quite easy to understand that many companies seek possibilities for a direct cross-border utilization of the losses of foreign subsidiaries. The first case in which the ECJ had to deal with the direct cross-border utilization of losses of a foreign group company was *Marks & Spencer* (Case C-446/03).[8] By insisting on the deductibility of only "final losses", the ECJ imposed some sort of ultimate responsibility on the Member State where the parent company is resident, but, at the same time, left ambiguous the legal and factual prerequisites for this obligation to become effective. More than eight years later and after numerous subsequent ECJ judgments, the substantive requirements for losses to be qualified as "final" are still highly controversial. Furthermore, it is the taxpayer who formally has to prove that all the available loss utilization possibilities have been exhausted. Given the existing lack of clarity, it can be no surprise that national courts in the European Union tend to apply the concept of final losses inconsistently. Thus, with a view to legal certainty, one can only hope that the ECJ clarifies the matter in its decisions in the upcoming cases.[9]

Despite the lack of a worldwide tax consolidation regime, some states (for example, France) might apply targeted measures to help domestic businesses to expand internationally. Other countries (for example, Canada) might not even have domestic group consolidation regimes and, therefore, rely on tax planning techniques instead of achieving a degree of matching income and losses within a related group of corporations.

4.3. Interim conclusions

Bearing in mind the rather modest possibilities for cross-border utilization of foreign losses, it is worth looking at the resolution which was adopted by the 1979 IFA Congress in Copenhagen. The Congress recommended:[10]

> 1. That the problem [of trapped foreign losses] be mitigated by extension of provisions for carryforward and carryback of losses both nationally and for purposes of the tax credit method of relief from international double taxation.

Although the panel of Seminar C did not deal with that issue in detail, it agreed that this mission has obviously not been accomplished.

> 2. That provisions be made for an extension of the "indirect" method of relief for the parent against losses of the subsidiary, for example by fiscal recognition of subventions or writing off the investment.[11]

Even without carrying out a comparison between the current and the 1979 rules in various countries, one can conclude that the situation has not really improved.

> 3. That in countries where worldwide consolidation is not practiced [i.e. still almost all countries] the parent company be entitled to exercise an option for all its subsidiary companies to be treated as permanent establishments for purposes of the parent

8. UK: ECJ, 13 Dec. 2005, Case C-446/03, *Marks & Spencer plc v. Halsey (Her Majesty's Inspector of Taxes)*, ECJ Case Law IBFD.
9. *Commission v. United Kingdom of Great Britain and Northern Ireland* (Case C-172/13) and *Nordea Bank Danmark* (Case C-48/13, regarding a PE).
10. *IFA Yearbook 1979* p. 76 (IFA 1979).
11. Id.

company's taxation, such option to be subject to restrictions in order to avoid misuse.[12]

Again, the problem of losses trapped in a foreign subsidiary is still existent. Interestingly, this recommendation explicitly mentions the need for appropriate anti-avoidance measures.

It seems that most states are not at all prepared to give relief for foreign subsidiaries' losses. However, states are less reluctant to introduce anti-avoidance rules.

5. Anti-Avoidance

5.1. General remarks

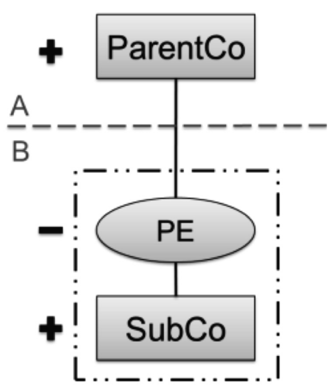
The tax systems of some countries provide for the possibility to indirectly use losses of a foreign subsidiary or allow the use of the company's "own" foreign PE losses. However, such cross-border loss utilization is often subject to anti-avoidance rules.

In 2011, the OECD completed a comprehensive study concerning aggressive tax planning involving corporate losses.[13] Based on a survey of a number of tax planning schemes on losses, the report identified three key risk areas in relation to the use of losses for tax purposes: corporate reorganizations, financial instruments and non-arm's length transfer pricing. As the OECD report clearly demonstrates, states are concerned about taxpayers claiming multiple deductions for the same loss. Therefore, an increasing number of countries have introduced special anti-avoidance rules preventing the dual use of losses or the dual use of deductions with respect to hybrid entities. Such situations were discussed by the panel on the basis of two case studies (*see* sections 5.2. and 5.3.)

5.2. Dual-consolidated loss rules

Example 2 focuses on the avoidance of double loss deduction by dual-consolidated loss (DCL) rules in general. The facts of the case can be summarized as follows:

Diagram 2: Dual-consolidated loss rules



ParentCo in State A maintains a PE or a tax transparent partnership in State B through which the shares in its subsidiary (SubCo) are held. Both the PE and SubCo are *bona fide* existing and operating. In year 1, the PE suffers a loss, whereas both ParentCo and SubCo are profitable. In year 2, the PE reports a profit as well.

According to the laws of state B, PE and SubCo form part of a tax group. Consequently, the losses incurred by PE in year 1 can be offset against SubCo's profits. ParentCo is tax resident in State A which either applies the credit method or the exemption method combined with a claw-back mechanism.

Without further restrictions, the PE losses of year 1 are – at least temporarily – used twice: once in the PE state under the group taxation regime and a second time in the residence state of ParentCo.

Under the exemption with claw-back method, this double deduction is only of a temporal nature if the losses are recaptured as soon as the PE (on a stand-alone basis) becomes profitable again in year 2.

This is also the result under the credit method provided that in year 2 State A is only prepared to give a foreign tax credit (FTC) that is based on the assumption that the PE uses its losses by means of a loss carry-forward (which would exist on a stand-alone basis but in fact does not exist because of group taxation in year 1). As a result, the FTC would be reduced in such a way that a claw-back of the losses deducted in year 1 took place. If, however, the residence state of ParentCo provides for a FTC that corresponds to the amount of taxes actually attributable to the PE in year 2, the automatic claw-back effect of the credit method fails. State A would give a tax credit even though no PE income is taxed from a multiyear perspective and the losses were used in the PE State B anyway.

Under these circumstances, the temporal double dip of year 1 turns into a permanent one. This raises the question of whether, how and, above all, which of the involved states should address this issue.

When discussing DCL rules more generally, the panel made clear that a DCL rule applied by State B would disallow the PE loss in State B if it was used in ParentCo's residence state and vice versa, i.e. if State A applied a similar rule, it would disallow the PE loss if it was already used abroad. But if there is no accompanying rule that provides for a deferred loss deduction in the event of future profits, double taxation might arise. Therefore, from a tax policy point of view, DCL rules should accommodate the fact that the double use of a loss is generally only of a temporary nature.

Another issue with the DCL rules is that they link the tax treatment of losses in one country to their tax treatment in another country. Hence, there is a need for a "tie-breaker" test to solve the issue when both countries rely on the treatment in the other country. If no such rule exists, the system might generate unrelieved double taxation in certain circumstances.

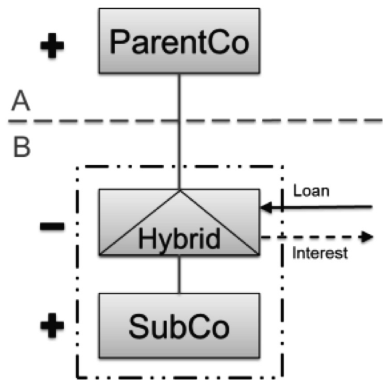
12. Id.
13. OECD, *Corporate Loss Utilisation through Aggressive Tax Planning* (OECD 2011), available at http://dx.doi.org/10.1787/9789264119222-en.

From the perspective of EU law, it has to be noted that DCL rules are problematic if they are applied by the source state of the losses as the ECJ decision in *Philips Electronics* (Case C-18/11)[14] clearly indicates. However, following the *Marks & Spencer*-doctrine, rules that avoid double loss utilization seem to be justified if they are applied by the residence state of the parent company to losses outside its own taxing jurisdiction.

5.3. Hybrid entities

The panel also discussed an example with respect to hybrid entities, taken from the OECD report on hybrid mismatch arrangements.[15] In that example (*see* Diagram 3), due to a hybrid mismatch arrangement, the same deduction is claimed twice in two different countries.

Diagram 3: Hybrid entities



ParentCo owns SubCo through a hybrid entity which is treated as tax transparent in State A and non-tax transparent in State B. The hybrid entity borrows funds and uses the loan amount to purchase additional equity in SubCo. The hybrid entity, which has no significant other income, is consolidated with SubCo for tax purposes. Therefore, it may offset its interest expenses against the income of SubCo and other group companies of State B. At the same time, the interest expenses may be deducted against the income of ParentCo in State A. A similar outcome could be achieved through a loss-making dual resident company benefitting from group relief/tax consolidation systems in both countries.

These kinds of arrangements raise significant policy concerns. Denmark, Germany, New Zealand, the United Kingdom and the United States have specific rules which address double deduction issues. The tax deduction is generally disallowed to the extent that the same deduction is claimed in the other country. In the absence of a "tie-breaker" test as mentioned in section 5.2. (i.e. if both countries apply similar rules), unrelieved double taxation might be the consequence. In its report on hybrid mismatch arrangements, the OECD recommends to countries that they consider introducing or revising specific and targeted rules denying benefits in the case of hybrid mismatch arrangements. As part of the BEPS Action Plan, published in July 2013,[16] the OECD announced that it would develop model treaty provisions and recommendations regarding the design of domestic rules to neutralize the double deduction effects of certain hybrid mismatch arrangements. Respective public discussion drafts were published on 19 March 2014.[17] Summing up, the BEPS project will not find any easy solutions.

6. The Planning Angle

6.1. Introductory remarks

As with many tax rules, legislators may cross their fingers and hope that their loss utilization restrictions are indeed targeted measures and do not impede cross-border business. However, in practice, such restrictions often tend to do so, as the statement of a former Global Head of Tax of a German DAX 30 Company indicates:

> With tax losses being deferred and often treated as non-deductible in an international context, how can global companies be criticised for trying to re-establish a closer proximity between economic results and relevant tax base through international tax planning?

This statement stresses that businesses which act globally tend to look at the global and thereby netted results. If the results happen to be partly profits and partly losses, management frequently wishes to overcome the resulting negative tax consequences by appropriate planning. Effective Tax Rate (ETR) considerations are certainly an important driver since the ETR can increase dramatically if taxes on isolated profits coincide with significant losses elsewhere in the group, so that the group's overall tax position does not correspond with economic reality.

The existing rules in many countries hardly satisfy these business needs or wishes. This may even be true for countries which provide for cross-border group taxation or for EU Member States which accept the importation of foreign *final* losses. Therefore, overly rigid limitations by states can lead to tax planning and tax driven business structures.

The question remains whether there are still planning opportunities which are acceptable for tax authorities and which are not at risk of being labelled "aggressive".

14. UK: ECJ, 6 Sep. 2012, Case C-18/11, *The Commissioners for Her Majesty's Revenue & Customs v. Philips Electronics UK Ltd*, ECJ Case Law IBFD.
15. OECD, *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues* (OECD 2012), International Organizations' Documentation IBFD, also available at www.oecd.org/ctp/aggressive/HYBRIDS_ENG_Final_October2012.pdf.
16. OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD 2013), International Organizations' Documentation IBFD, also available at www.oecd.org/tax/beps.htm.
17. OECD, *Public Discussion Draft: BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)* (OECD 2014). The draft also covers situations such as those in Example 2 (discussed above), which do not involve hybrid entities. It recognizes the fact that a double use of losses (expenses) may only be of a temporary nature and that rules in two countries must not be applied simultaneously. The second draft on treaty issues (OECD, *Public Discussion Draft: BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Treaty Issues)* (OECD 2014)) also touches upon cross-border loss utilization but is less relevant with regard to the Seminar's discussions.

The panel did not aim to answer that question but presented some planning techniques which may help businesses to match cross-border profits and losses particularly in the absence of cross-border group taxation regimes. Whether these planning techniques would work in specific countries is of course always subject to the particular country's tax laws. Hence, the following examples were meant only as food for thought.

6.2. Debt waivers, subsidies and sale of shares

One common way of repatriating losses of foreign subsidiaries or PEs is through the use of debt waivers or subsidies provided that they are treated as tax deductible expenses at the level of the parent company.

Another tax planning example presented by the panel was based on an intra-group alienation of shares. SubCo owes 100 to foreign profitable ParentCo. Since SubCo is in financial distress, the fair market value (FMV) of the claim is 10. ParentCo subscribes for new shares in SubCo. SubCo's issued share capital is increased by 100.[18] ParentCo pays for the issued shares with its claim. The shares are worth 10. ParentCo books the shares for 100 and sells them to PurchaseCo, a related company, for their FMV, i.e. 10.

The expected outcome is that ParentCo claims a tax deduction for the loss; at the same time, there is no profit recognition at the level of SubCo. Just as in the previous cases, it has to be borne in mind that national law might restrict the deduction of the realized loss or even treat the sale as a tax neutral event. National law might also enforce a profit recognition at SubCo level.

6.3. Recapitalization

The panel also presented a Canadian tax planning example.

A Canadian subsidiary is profitable, while its foreign parent corporation has accumulated losses. Given the difference between the Canadian corporation's income tax rate on profits (typically between 25% and 31%) and the applicable Canadian interest withholding tax (10% in most treaties, 0% in the Canada-United States Income and Capital Tax Treaty (1980)),[19] intra-group financing of the profitable Canadian subsidiary may effectively use losses by creating interest expense in Canada and interest income in the foreign jurisdiction where losses are available to shelter it. This form of tax planning is relatively simple to implement since it does not involve the movement or creation of business functions, but instead it utilizes local interest expense deductibility rules to generate tax-deductible financing expenses within the permitted limits.

Foreign ParentCo is presumed to have invested CAD 100 in the share capital of the Canadian entity CanCo. This amount of invested share capital is reflected for Canadian tax purposes as CAD 100 of "paid-up capital" ("PUC"), which is a particularly valuable tax attribute in a cross-border context, since Canadian tax rules:

- use PUC as the basis for the cross-border thin capitalization rules; and
- allow PUC to be repatriated from Canada without triggering dividend withholding tax.

ParentCo makes a loan of CAD 40 to CanCo, which uses these funds to distribute CAD 40 back to ParentCo as a reduction of share capital (distribution of PUC for tax purposes), with the result that CanCo has CAD 40 more of debt and CAD 40 less of equity.

On the loan side of the transaction, interest on money borrowed for an income-earning purpose may be deducted in computing income. Under Canadian tax law and administrative policy of the Canada Revenue Agency (CRA), a Canadian corporation may borrow on an interest-deductible basis to return capital to the extent of the corporation's contributed capital and accumulated profits. As such, borrowing CAD 40 to return CAD 40 of PUC should satisfy this test.

Canada's thin capitalization rules limit the amount of interest-deductible debt; in the example, the debt/equity ratio is acceptable.

The CAD 40 PUC return is not (and is not deemed to be) a dividend and reduces the cost basis of ParentCo's shares of SubCo by CAD 40. Depending on the applicable laws, this may or may not trigger a taxable gain upon a later sale of the shares.

6.4. Transfer of income-generating assets and sale of low/no income-generating assets

Whereas in the structure above the goal of cross-border loss utilization was reached without any movement or creation of business functions, the panel also discussed two cases in which the loss utilization possibility is primarily based on a transfer of assets within the group.

In both cases a profit-making ParentCo has a foreign loss-making SubCo.

In the first case, ParentCo owns income-generating assets which it transfers to SubCo as a capital contribution or in exchange for shares of SubCo. Hence, taxable income is moved out of ParentCo and into SubCo.

However, a capital gains tax at the level of ParentCo might reduce, if not eliminate, the expected tax benefits. The group will, therefore, try to transfer the assets at the lowest acceptable price or make optimal use of favourable ParentCo tax attributes in order to minimize the capital gain.

In the second case, SubCo owns low/no taxable income-generating assets (for example, shares in a subsidiary) which it sells to ParentCo in exchange for interest-bearing debt. ParentCo deducts the interest expense. SubCo's interest income is offset by its current losses or loss carry-forwards.

18. This might not work in every country: in some cases, the share capital is only increased in the amount of the fair market value. However, the example is based on French law where such increase is possible.
19. *Convention between Canada and the United States of America with Respect to Taxes on Income and on Capital* (26 Sept. 1980) (as amended through 2007), Treaties IBFD.

7. Outlook and Conclusions

Seen from an overall perspective, the panel discussion revealed one important feature of the topic of cross-border loss utilization: the gap between the concerns expressed by the business community and the overall evolution of the international rules, which might become even more accelerated due to the OECD's BEPS project.

After all, businesses are concerned with double taxation issues in circumstances where foreign losses are lost or cannot be used in the source country and, at the same time, cannot be offset in the home country. Therefore, the panel agreed that the business perspective should be duly taken into account by the legislators. The guideline for future legislative processes ought to be that business decisions should not be impacted by tax considerations and that offsetting of losses against future profits is justified.

In an international arena, the coordination of tax rules between states would be desirable as well since most cases of double non-taxation or double taxation in the context of loss utilization are the result of mismatches in the national rules. But even within the European Union, the road to more co-ordination, not to mention harmonization, is long and stony.

The European Commission addressed the issue of losses, without any success, already in 1984 and 1990 with Proposals for a Council Directive.[20] In 2006, it put this topic on its agenda again.[21] In 2008, the European Parliament issued a resolution which called for adequate coordination between Member States in that area.[22] Furthermore, the Parliament clearly supported the Commission's efforts to establish a pan-European common consolidated corporate tax base (CCCTB), which would have solved the problem, at least for groups of companies. This was all more than five years ago. Today, the CCCTB initiative is not progressing and so no steps have been taken by the Member States to provide for coordinated loss compensation rules within the European Union. It remains to be seen whether the latest reconfirmation by France and Germany that they will come forward with new joint suggestions on the proposal for a Council Directive on a CCCTB will get things going again.

On the other hand, through the OECD BEPS Action Plan, the emphasis has now been placed on a totally different issue, i.e. the need to address "base erosion and profit shifting". Nevertheless, the avoidance of double taxation should also remain on the agenda, since not all problems in this respect have been solved – and new issues might even arise due to the BEPS project (for example, faster assumption of a PE in one state while the other state denies the PE and taxes the income).

One would like to strike the right balance between the legitimate request for the elimination of overtaxation as a result of true losses becoming stranded in foreign entities and the equally legitimate need to prevent companies from taking losses (ultimately) into account twice in two different jurisdictions without any compensation by profits.

In this context, it should also be noted that more and more businesses are refraining from making use of tax saving opportunities because of business reasons, including being "named and shamed" in the media for tax avoidance, or in order to avoid disputes with the tax authorities.

However, no one will contest the fact that there is a lot of tax planning going on, including a beneficial use of losses. This is understandable as company managements have an obligation to increase the company's wealth and profits, measured on an after tax basis. "In most cases, business is just using the rules that governments themselves have put in place. It is therefore governments' responsibility to revise the rules or introduce new ones."[23] The panel's discussion has shown that, with regard to cross-border loss situations, there is still a long way to go for such new rules to be effective but fair and appropriate.

To summarize the results and views expressed by the panel members, it is fair to say that cross-border loss utilization remains an issue for business as well as for governments. In many countries, many of the rules are not completely satisfactory. This is true from a systematic and policy point of view as well as from a business perspective. Anti-avoidance rules are, of course, legitimate. Nevertheless, their introduction requires good judgement by policy makers of what is really necessary – in a triangle between justified business needs, legal certainty for cross-border commercial activities and the public interest.

20. COM(84) 404 final, COM(90) 595 final.
21. European Commission, *Tax Treatment of Losses in Cross-Border Situations*, COM(2006) 824 final.
22. European Parliament, Resolution of 15 January 2008 on Tax Treatment of Losses in Cross-Border Situations, 2007/2144(INI).
23. OECD, *BEPS – Frequently Asked Questions*, available at http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm.