

# Cross-Border Restructuring and “Final Losses”

**In this article, the authors discuss loss compensation in connection with cross-border reorganizations, in particular the extent to which the “no possibilities” test can be relied on in claiming compensation for “final losses”.**

## 1. Introduction

On 13 December 2005, the ECJ handed down a decision that would spur a heated academic debate: *Marks & Spencer* (Case C-247/08).<sup>1</sup> Marks & Spencer plc, a UK resident company, held several continental European subsidiaries that had become loss-making during the 1990s.<sup>2</sup> Under the United Kingdom’s group relief regime, Marks & Spencer sought to offset these losses against its UK profits. Group relief, however, was only available to UK resident companies or non-resident companies that carried on trade in the United Kingdom through a permanent establishment (PE).<sup>3</sup> Marks & Spencer was, therefore, denied the requested cross-border group relief. According to the ECJ, this constituted a restriction on the freedom of establishment that was, however, justified based on a threefold justification ground: preserving a balanced allocation of taxing powers, preventing losses from being used twice, and averting tax avoidance.<sup>4</sup> However, when the ECJ assessed the proportionality of the outright denial of cross-border group relief, it held that allowing for the compensation of “final losses” (losses that had become

exhausted in the subsidiaries’ Member States) would make the United Kingdom’s group relief regime less restrictive.<sup>5</sup>

In this contribution, the authors review to what extent this “no possibilities test” can be relied upon to ensure compensation for “final losses” arising in connection with cross-border restructuring operations. The relevance of this topic has been reignited by *A Oy* (Case C-123/11), in respect of which Advocate General Kokott delivered her Opinion on 19 July 2012 (*see* section 4.).<sup>6</sup>

## 2. A Broader Perspective

*Marks & Spencer* should be assessed in the context of a series of ECJ cases comprising, inter alia, *Schumacker* (Case C-279/93)<sup>7</sup> and *Renneberg* (Case C-527/06).<sup>8</sup> These cases concern loss compensation or the granting of personal allowances (splitting tariff, mortgage interest deduction, etc.) in cross-border situations.

*Schumacker* dealt with a Belgian national who worked in Germany and who earned his household’s sole income in that state. Mr Schumacker was refused the right to claim the “splitting tariff”, which was only applicable to married employed persons residing in Germany. The ECJ held that, generally, a source state may refuse to grant non-residents certain personal allowances that it grants to residents, since, as a rule, the situations of residents and non-residents are not comparable. The ECJ, however, formulated an important exception to this rule where the non-resident’s income in his state of residence is insignificant and he obtains the majority of his taxable income in the source state.<sup>9</sup> In this situation, refusing to grant to non-residents the personal allowances available to residents would be tantamount to discrimination in the ECJ’s view.

*Renneberg* concerned a Netherlands national who resided in Belgium and who earned all of his income in the Netherlands. Mr Renneberg sought to deduct the interest expense on his mortgage (used to finance his Belgian home) against his Netherlands income. A mortgage interest deduction, however, was only available to Netherlands residents.<sup>10</sup> The ECJ extended the scope of the *Schumacker*

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1. UK: ECJ, 13 Dec. 2005, Case C-247/08, *Marks & Spencer plc v. David Halsey* (Her Majesty’s Inspector of Taxes), ECJ Case Law IBFD. See, inter alia, P.J. Wattel, *Annotation to Marks & Spencer*, BNB 72 (2006) and A. Cordewener, G. Kofler & S. van Thiel, *The Clash Between European Freedoms and National Direct Tax Law: Public Interest Defenses available to Member States*, 46 Common Market Law Rev., pp. 1990-1995 (2009).
2. For a discussion of *Marks & Spencer* and its implications, see S.C.W. Douma & C. Naumberg, *Marks & Spencer: Are National Tax Systems Éclairé?*, 46 Eur. Taxn. 9, pp. 431-442 (2006), Journals IBFD.
3. The United Kingdom’s group relief rules that applied for accounting periods ending on or before 31 March 2000 required both the surrendering company and the claimant company to be resident in the United Kingdom (UK: Income and Corporation Taxes Act (ICTA), sec. 413(5), National Legislation IBFD). For later periods, the availability of group relief has been extended to non-resident companies that carry on trade in the United Kingdom through a branch or an agency (sec. 402(2) (b) ICTA). See P. Farmer & A. Last, *The Marks & Spencer Group Relief Litigation: The No Possibilities Test*, in *From Marks & Spencer to X Holding. The Future of Cross-Border Group Taxation* p. 97 (D.M. Weber & B. da Silva eds., Kluwer Law International 2011).
4. *Marks & Spencer* (C-247/08), paras. 42-51.

5. *Marks & Spencer* (C-247/08), para. 55.

6. FI: ECJ, Opinion of Advocate General Kokott, 19 July 2012, Case C-123/11, *Veronsaajien oikeudenvalvontayksikkö and Valtiovarainministeriö v. A Oy*, ECJ Case Law IBFD. For a discussion of the *A Oy* case, see M. Helminen, *Must the Residence State Allow a Deduction for Foreign-Source Losses in the European Union?*, 51 Eur. Taxn. 11, pp. 477-482 (2011), Journals IBFD.

7. DE: ECJ, 14 Feb. 1995, Case C-279/93, *Finanzamt Köln-Alstadt v. Roland Schumacker*, ECJ Case Law IBFD.

8. NL: ECJ, 16 Oct. 2008, Case C-527/06, *R.H.H. Renneberg v. Staatssecretaris van Financiën*, ECJ Case Law IBFD.

9. *Schumacker* (C-279/93).

10. With either immovable property in the Netherlands that the Netherlands resident occupies himself or with immovable property in Belgium that the Netherlands resident does not himself occupy on a permanent basis. See *Renneberg* (C-527/06), para. 65.

decision by imposing an obligation on the Netherlands to allow the interest deduction, even though the right to tax the income derived from the Belgian immovable property was allocated exclusively to Belgium under the Netherlands-Belgium Income and Capital Tax Treaty (2001).<sup>11</sup>

In *Schumacker, Marks & Spencer* and *Renneberg*, the ECJ recognized the need to preserve a balanced allocation of taxing powers between Member States. As a rule, therefore, residents and non-residents may be treated differently by the Member States concerned. However, according to the ECJ, an exception should be made to this main rule where the infringement of an EU fundamental freedom is disproportionate in relation to the objective pursued by the national measure. In these circumstances, Member States must remove the unequal treatment produced by the national measure.

### 3. Balanced Allocation of Taxing Powers

As the ECJ recognizes that the need to preserve a balanced allocation of taxing powers may justify restrictions on the freedom of establishment, taxpayers who have sought to “import” foreign losses have hit a brick wall in a number of cases.

In *Oy AA* (Case C-231/05), a Finnish company requested that the Finnish tax authorities accept a transfer of Finnish profits to its loss-making UK parent company.<sup>12</sup> The Finnish group contribution rules restricted such transfers by requiring that the transferor and transferee be Finnish resident companies. Although the ECJ viewed this as a restriction of the freedom of establishment, it acknowledged that this restriction could be justified by the need to safeguard a balanced allocation of taxing powers and the need to prevent tax avoidance.

In *Lidl Belgium* (Case C-414/06),<sup>13</sup> a German resident company was denied the possibility to deduct losses incurred by its Luxembourg PE, whereas, if the losses were incurred by a German PE, they would have been deductible. According to the ECJ, the preservation of a balanced allocation of taxing powers between Germany and Luxembourg might necessitate only applying the tax rules of that Member State to the Luxembourg PE, in respect of both profits and losses. The ECJ then cited the *Marks & Spencer* decision and reiterated that this only holds true if the possibilities for having the losses taken into account in Luxembourg have not been exhausted.

In *Krankenheim Wannsee* (Case C-157/07),<sup>14</sup> a German resident company carried on business through an Austrian PE. Initially, the Austrian PE was loss-making and, under the then applicable rules, its losses were taken into

account at the level of the German head office. In Austria, losses were only compensated if it was not possible to take the losses into account in Germany. When the Austrian PE became profitable, the previously deducted losses were recaptured at the level of the German head office. The German legislation would not have provided for such recapture if the taxpayer had shown that the Austrian rules did not, in general, allow for compensation of its Austrian losses (*quod non*). In regard to a German PE, however, no recapture would have occurred at all. Accordingly, the tax situation of a German resident company with an Austrian PE was less favourable than it would have been if the latter had been established in Germany. The ECJ held that the “logical symmetry” of recapturing the previously deducted losses was necessary to guarantee the coherence of the German tax system and hence establish that the restriction that followed from the recapture was justified. The fact that the possibility to compensate the losses under the Austrian rules could not be put into effect in the specific situation, and hence, that the taxpayer ended up with a “final loss”, was treated as a disparity by the ECJ. In other words, as a disadvantage that did not arise from the German tax system itself, but from the allocation of taxing powers between Germany and Austria.

Finally, in *X Holding BV* (Case C-337/08), a Netherlands resident parent company sought to form a fiscal unity with its loss-making Belgian resident subsidiary.<sup>15</sup> A request thereto was denied, as the Netherlands fiscal unity regime was only open to Netherlands resident companies and companies carrying on business in the Netherlands through a PE. Just as in *Oy AA*, the ECJ recognized that the freedom of establishment had been infringed, but accepted the justification of the need to safeguard the allocation of taxing powers between the Member States.

### 4. Advocate General Kokott’s Opinion in the A Oy Case

In the *A Oy* case, the ECJ will have the opportunity to further develop the “no possibilities” test it introduced in *Marks & Spencer*. Prior to this, it will have to indicate whether or not this test can also be invoked if a Member State’s restrictive tax rules are not (partially) justified by the need to prevent losses from being used twice. At the time this article was written, only Advocate General Kokott’s Opinion of 19 July 2012 was at the authors’ disposal. In section 4. the authors address the facts of the *A Oy* case and the AG’s view on the applicability of the “no possibilities test”. Section 5. (also) addresses the AG’s interpretation of the conditions of the “no possibilities” test.

*A Oy* concerns a Swedish transferring company that had merged into a Finnish receiving company, *A Oy*. The Swedish company had losses available for carry-forward, but it no longer carried out any business activities in Sweden. Owing to practical difficulties, it turned out to be impossible to effectively offset the Swedish losses against the profits of Swedish group companies. There-

11. *Convention between the Kingdom of Belgium and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital* [unofficial translation] (5 June 2001), Treaties IBFD.

12. FI: ECJ, 18 July 2007, Case C-231/05, *Oy AA*, ECJ Case Law IBFD.

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

14. DE: ECJ, 23 Oct. 2008, Case C-157/07, *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH v. Finanzamt für Körperschaften III in Berlin*, ECJ Case Law IBFD.

15. NL: ECJ, 25 Feb. 2010, Case C-337/08, *X Holding BV v. Staatssecretaris van Financiën*, ECJ Case Law IBFD.

fore, A Oy asked the Finnish tax authorities to allow for compensation of the Swedish losses against its Finnish profits. The Finnish tax rules, however, only allow for the transfer of losses to a receiving company under a purely Finnish merger.

The AG notes that the Finnish tax rules constitute a restriction on the freedom of establishment, as they allow a Finnish parent company to use the losses of a Finnish subsidiary in the event of a merger, but do not allow for this if the losses are from a business activity in another Member State that is not subject to Finnish tax.<sup>16</sup>

Addressing the justification for this restriction, the AG discusses Finland's right to preserve a balanced allocation of taxing powers between Finland and Sweden. She refers to article 7(1) of the Nordic Convention (1996)<sup>17</sup> – which provides that the business activity of the Swedish company falls within the exclusive power of taxation of Sweden – and concludes that Finland's power of taxation would be impaired if it had to take into account losses from an activity that it cannot tax.<sup>18</sup>

The AG then examines whether or not the Finnish rules go further than what is necessary to achieve the objective of preserving a balanced allocation of taxing powers. She discusses the applicability of the *Marks & Spencer* exception. Here, she follows an original line of thought. She argues that that this exception can only be understood against the background of the justifications considered in *Marks & Spencer*, which not only include the objective of preserving a balanced allocation of taxing powers, but also the right to prevent losses from being used twice. In light of the latter objective, a national measure is disproportionate if it prevents a parent company from taking into account losses incurred by a foreign subsidiary, where the losses have been exhausted in the Member State of the subsidiary. According to the AG, however, the ECJ's case law has evolved since *Marks & Spencer* and the objective of preserving a balanced allocation of taxing powers has become a crucial, independent justification ground. By contrast, the objective of preventing double loss utilization is not an autonomous justification in the AG's view. She, therefore, contends that the “no possibilities” test can no longer be applied if a justification is based on the need to preserve a balanced allocation of taxing powers.

With regard to this justification ground, Kokott notes that it is only relevant to the issue of which taxing power a loss belongs to; it does not relate to the issue of whether or not the possibilities for using the loss in the Member State that has the power to tax a particular business activity have been exhausted. In fact, if a Member State has to take into account losses incurred in another Member State that can no longer be used there, she argues, the objective of preserving a balanced allocation of taxing powers would not be achieved at all. The decision in *X Holding BV* – where

the ECJ based the justification solely on the need to preserve a balanced allocation of taxing powers and did not refer to the “no possibilities” test – was, therefore, correct in Kokott's view. Accordingly, Kokott takes the position that the Finnish refusal to transfer Swedish losses is necessary in view of the objective of preserving a balanced allocation of taxing powers. It is then irrelevant whether or not the losses of the Swedish subsidiary were exhausted in that Member State.<sup>19</sup>

A few observations should be made with regard to the AG's Opinion. Although Kokott correctly notes that the need to preserve a balanced allocation has achieved a pivotal role in the ECJ's case law on cross-border loss relief, this does not imply that the “no possibilities” test has lost its significance. The ECJ simply did not have to invoke this test in cases where only the balanced allocation of taxing powers was at stake, as none of these cases, including *X Holding BV*, actually concerned “final losses”. In addition, the authors do not share the AG's view that the objective of preventing the double use of losses is not an autonomous justification. In the authors' view, any objective, as long as it is a legitimate objective that is compatible with the Treaty on the Functioning of the European Union (2007),<sup>20</sup> can qualify as an autonomous justification.<sup>21</sup> Furthermore, although Kokott correctly observes that the objective of preserving a balanced allocation of taxing powers is not achieved if a Member State is required to take into account losses incurred under the taxing power of another Member State, this, in itself, is not a convincing argument to disapply the “no possibilities” test. After all, the overriding need to preserve a balanced allocation of taxing powers can be regarded as a logical outcome of a balancing act between the Member States' fiscal sovereignty in the area of direct taxation and the free movement provisions. If the adverse affect on free movement is too severe, a Member State's national tax measure may have to give way to free movement, irrespective of the legitimacy of that measure's objective. A parallel may be drawn here to a (heated) discussion in an entirely different field, namely the right of Muslim women to wear a headscarf. During the London Olympics, a Saudi Arabian judoka wished to play judo while wearing a headscarf. Here, her freedom of religion had to be weighed against the “principles and spirit” of judo and general safety rules.<sup>22</sup> Ultimately, a compromise was reached where she was allowed to wear a “safe”, bathing cap-like headscarf. By contrast, if a Muslim female judge wants to wear a headscarf in the courtroom, her freedom of religion would be balanced

16. AG Opinion in *A Oy* (C-123/11), para. 35.  
 17. *Convention between the Nordic Countries for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital* (23 Sept. 1996), Treaties IBFD.  
 18. AG Opinion in *A Oy* (C-123/11), para. 44.

19. AG Opinion in *A Oy* (C-123/11), paras. 48-54.  
 20. Treaty on the Functioning of the European Union of 13 December 2007, OJ C115 (2008), EU Law IBFD. See UK: ECJ, 12 Dec. 2006, Case C-446/04, *Test Claimants in the Franked Investment Income Group Litigation v. Commissioners of Inland Revenue*, para. 133, ECJ Case Law IBFD.  
 21. In *Lidl Belgium* (C-414/06), para. 37, concerning the justifications based on (1) the need to preserve a balanced allocation of taxing powers and (2) the need to prevent the danger that losses may be taken into account twice, the ECJ observed that “[...] the two justifications put forward must each be considered as being capable of justifying a restriction on the freedom of establishment [...]”.  
 22. See <http://edition.cnn.com/2012/07/30/sport/olympics-saudi-judo-hijab/index.html>.

against the principle of neutrality of the judiciary. In many non-Muslim states, the latter principle prevails and she would not be allowed to do so under any circumstances.

## 5. The “No Possibilities” Test

### 5.1. Introduction

What emerges from sections 2. and 3. is that the ECJ has erected a barrier against the cross-border compensation of losses by attaching importance to the need to preserve a balanced allocation of taxing powers. A loophole remains, however, where the issue is the compensation of “final losses”.

In *Marks & Spencer*, the ECJ formulated the conditions under which losses can be characterized as “final losses”:<sup>23</sup>

- 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 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.

Losses are thus exhausted if a series of cumulative requirements are met: (1) the subsidiary’s losses cannot be carried forward, nor can they be carried back against the subsidiary’s own profits, (2) the subsidiary’s losses cannot be utilized by transferring them to a third party; and (3) the subsidiary’s losses cannot be utilized by a third party, in particular where the subsidiary has been sold to that third party. If these conditions are fulfilled, the freedom of establishment prevails over a given allocation of taxing powers provided the exercise of the latter powers places a disproportionate burden on the exercise of this fundamental freedom.

The interpretation of the “no possibilities” test was in dispute in, inter alia, the post-*Marks & Spencer* litigation in the United Kingdom and in two decisions of the German Federal Tax Court (*Bundesfinanzhof*) of 9 June 2010.<sup>24</sup> In sections 5.2. and 5.3. the authors compare (and comment on) the views expressed by these national courts on several elements of the concept of “final losses”. The positions taken by Advocate General Kokott in her Opinion in the *A Oy* case are also addressed.

### 5.2. Legal or factual exhaustion

In the *Marks & Spencer* decision, the ECJ did not specify whether the “no possibilities” test requires *legal* exhaustion, or whether this test (also) requires *factual* exhaustion of the possibilities of loss compensation. To exemplify the

23. *Marks & Spencer* (C-247/08), para. 55.

24. DE: Federal Tax Court (*Bundesfinanzhof*), 9 June 2010, I R 100/09 and I R 107/09.

distinction between these concepts, *legal* exhaustion of the possibilities to take into account losses exists where, for instance, a carry forward term for loss utilization expires and losses become “final”. *Factual* exhaustion occurs, for example, where a loss-making foreign subsidiary is liquidated and its activities cease.

In the *Marks & Spencer* litigation following the ECJ’s decision, various UK courts addressed this matter. The first was the High Court where Park J interpreted the “no possibilities” test as meaning,<sup>25</sup> “recognised possibilities legally available given the objective facts of the company’s situation at the relevant time”.

The Court of Appeal also clarified what was meant by this test. Chadwick LJ held that its conditions would not be satisfied:<sup>26</sup>

[...] if the claimant did no more than demonstrate that it was improbable or unlikely, or that there was little or no real likelihood, or that the claimant (or the surrendering company) had no intention, that losses could or would be set against future profits. [...] Given the context, the phrase ‘no possibility’ in the second condition is to be read as ‘no real possibility’; in the sense that a real possibility is one which cannot be dismissed as fanciful.

Following appeals to the First-tier Tribunal and the Upper Tribunal, one of the questions before the Court of Appeal was whether the “no possibilities” test should be performed on the basis of the facts of an individual case or whether this test should be regarded as a matter of principle.<sup>27</sup> The UK Revenue had submitted that once a surrendering company is permitted to satisfy the conditions of the “no possibilities” test by reference to its particular factual situation at the time of its claim, it offers the taxpayer the opportunity to choose where the losses may be relieved. Ironically, this could give rise to the “trafficking of losses”, which the ECJ had sought to prevent in *Marks & Spencer*.<sup>28</sup> The Court of Appeal, however, concluded that it was bound by the decision to answer the question of whether or not the “no possibilities” test had been met by reference to the facts as at the date of the claim. These objective facts would have to show whether there was a real, as opposed to a fanciful, possibility for losses to be taken into account in future periods.<sup>29</sup>

As the German Federal Tax Court decisions on 9 June 2010 have received extensive coverage in the academic literature,<sup>30</sup> the authors confine themselves to a concise summary here. Case *IR 100/09* (2010)<sup>31</sup> involved a German resident company that carried on business through a loss-making French PE. The French losses that were incurred in 1999 expired in 2004 owing to a five-year restriction

25. UK: HC, 11 Apr. 2006, *Marks & Spencer plc v. Halsey* (*Inspector of Taxes*), [2006] EWHC 811 Ch; [2006] STC 1235.

26. UK: CA, 20 Feb. 2007, *Marks & Spencer plc v. Halsey* (*Inspector of Taxes*), [2007] EWCA Civ 117; [2008] STC 526.

27. UK: CA, 14 Oct. 2011, *HMRC v. Marks & Spencer*, [2011] EWCA Civ 1156, para. 26.

28. *HMRC v. Marks & Spencer* (2011), paras. 27-29. See also P.J. Wattel’s annotation to *Marks & Spencer*, *supra* n. 1, point 21.

29. *HMRC v. Marks & Spencer* (2011), para. 46.

30. See, inter alia, A. Bal, *New Case Law Developments in Germany: Finality of Foreign Permanent Establishment Losses*, 52 *Eur. Taxn.* 1, p. 46 (2012), *Journals IBFD*.

31. DE: FTC, 9 June 2010, I R 100/09.

on the carry forward of losses under French tax law. In 2005, the PE's activities ceased. Case *IR 107/09* (2010)<sup>32</sup> also concerned a German resident company carrying on its business through a French PE. It incurred French losses in the period 1998-2001, until the French activities were liquidated in September 2001. The 2000 and 2001 losses could not be utilized by way of carry back or carry forward. In both cases, the German resident company sought to offset the French losses against its German taxable income.

In Case *IR 100/09*, the German Federal Tax Court rejected the notion that *legal* exhaustion would suffice to meet the conditions of the “no possibilities” test. Accordingly, it denied compensation for the 1999 loss. Although this loss had also become *factually* exhausted in 2005 due to the French activities ceasing, the Court did not relent; it observed that the finality of the loss in France was caused by the expiration of the five-year carry-forward term. It regarded the impossibility of deducting the French loss as a disparity,<sup>33</sup> therefore, not compelling Germany to allow for cross-border loss-relief. In contrast to Case *IR 100/09*, in Case *IR 107/09*, the Court did accept the cross-border compensation of the French losses, as these losses had become *factually* exhausted in 2001 due to the liquidation of the French activities. In *obiter dictum*, the Court noted that exhaustion of losses could also be triggered by a conversion of a PE into a subsidiary or by the transfer of the assets and liabilities of a PE to a third party.<sup>34</sup>

In her Opinion in the *A Oy* case, Advocate General Kokott is critical of the application of the “no possibilities” test in regard to a merger. She more or less has the same suspicions as the UK Revenue in the post-*Marks & Spencer* litigation: in deciding on a merger, merging companies can freely choose the place where the losses of the transferring company are taken into account. In particular, she expresses the concern that the transferring company would forgo the possibility of using its loss, for instance, through a deliberately belated application for an accumulated loss to be taken into account.<sup>35</sup>

In the authors' view, both *legal* and *factual* exhaustion of the possibilities of loss utilization in the Member State of the subsidiary (M/S S) should give rise to compensation of these losses in the Member State of the parent company (M/S P). Naturally, it should first be established that losses incurred by a *resident* subsidiary would also have been deductible at the level of the parent company. The authors reject the Court's refusal to accept compensation of *legally* exhausted losses for two reasons.

First, that outcome implies an artificial incentive to cease foreign activities solely because of expiring losses, rather than continuing the activities and aiming for future profitability. If the expired losses are start-up losses that are incurred in regard to the entire activity carried on in M/S

32. DE: FTC, 9 June 2010, IR 107/09.

33. In para. 10 it referred, inter alia, to DE: ECJ, 28 Feb. 2008, Case C-293/06, *Deutsche Shell GmbH v. Finanzamt für Grossunternehmen in Hamburg*, para. 42, ECJ Case Law IBFD.

34. These transactions are listed in DE: Income Tax Act (*Einkommensteuergesetz*) art. 2a(4), National Legislation IBFD.

35. AG Opinion in *A Oy* (C-123/11), paras. 55-60.

S, it is easy to identify the *legally* exhausted losses, but it would be commercially undesirable to transform these losses into *factually* exhausted losses, as that would entail ceasing the activity in its entirety in M/S S.

Second, the authors do not regard losses arising out of *legal* exhaustion as disparities: they are disadvantages caused by discriminatory loss-relief rules in M/S P, which, under the conditions laid down in *Marks & Spencer*, should also be removed by that Member State.

### 5.3. Different tax rules in M/S P and M/S S

The identification of “final losses” and their calculation becomes even more complicated in the face of differences between the tax rules of M/S P and M/S S. In *Marks & Spencer*, the ECJ did not have to touch upon this sensitive matter,<sup>36</sup> as “[i]t is clear from the file before the Court that both parties to the main proceedings agree that the losses must be computed on a United Kingdom tax basis.”

If no agreement is reached on the computation of the losses, at one end of the scale, there may be *temporary* differences in the calculation of the amount of the losses, for instance, due to different rules regarding the depreciation of immovable property. At the other end of the scale, the calculation of the amount of “final losses” may be affected by *permanent* differences created, for example, by varying thin capitalization rules. In this sense, it may even happen that a subsidiary will be loss-making according to the tax rules of M/S S, but profitable according to the tax rules of M/S P.<sup>37</sup>

In the post-*Marks & Spencer* litigation in the United Kingdom, the Court of Appeal addressed the problem of a loss being recognized in M/S P in year one, but not being recognized in M/S S until year two. *Marks & Spencer* had contended, and the Tribunals had agreed, that group relief should be available in year one, although the relevant subsidiary did not suffer any losses in that year.<sup>38</sup> The UK Revenue challenged this view, arguing that the difference in timing of the loss “is merely the inevitable consequence of the two different tax systems”.<sup>39</sup> Hence, the UK Revenue sought to dispose of the matter by treating it as a “disparity”, outside the scope of the free movement provisions.<sup>40</sup> The Court of Appeal dismissed this argument emphasizing that the comparison that should be made is with the situation of losses being sustained by a UK resident

36. *Marks & Spencer* (C-247/08), para. 22. As Lang observes, it, therefore, remains an outstanding question how one should cope with these differences. See M. Lang, *The Marks & Spencer Case – The Open Issues Following the ECJ's Final Word*, 46 Eur. Taxn. 2, p. 62 (2006), Journals IBFD.

37. Of course, the reverse is also possible: the company could be profitable according to the tax rules of M/S S, but loss making according to the tax rules of M/S P.

38. *HMRC v. Marks & Spencer* (2011), para. 76.

39. *HMRC v. Marks & Spencer* (2011), para. 85.

40. The UK Revenue, inter alia, suggested that the key to resolving the controversy was in UK: Opinion of Advocate General Geelhoed, 23 Feb. 2006, Case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation v. Commissioners of Inland Revenue*, para. 65, ECJ Case Law IBFD, in which Advocate General Geelhoed acknowledged that the co-existence of discrete national tax systems entails disparities between these systems.

subsidiary. Accordingly, it held that the losses should be deductible in year one despite reallocating the losses to a different accounting period.<sup>41</sup>

In her Opinion in the *A Oy* case, Advocate General Kokott argues that the losses to be taken into account must *in principle* be calculated according to the tax law of M/S P. She considers this necessary to achieve an equal treatment between cases within a single Member State and cross-border situations. Kokott dismisses the submissions of the Commission and the Finnish that the loss to be taken into account should be maximized according to the amount calculated under the tax law of M/S S; such a limitation would obstruct the attainment of the desired equal treatment between an inland and a cross-border merger.<sup>42</sup> Kokott sees one possible exception to the main rule that losses are to be calculated according to the rules in M/S P, and that is where the loss in M/S S is increased, for instance, by tax incentives in M/S S, such as higher depreciation. In those cases, M/S P may “ignore” the increased amount of the loss.

In the authors’ view, in determining the extent to which losses are to be taken into account in M/S P, the point of departure from the ECJ’s case law is that the freedom of establishment’s objective is to remove disproportionate impediments to cross-border establishment.<sup>43</sup> This means that Member States may not neutralize the budgetary consequences of cross-border establishment by imposing a compensatory levy on the taxpayer<sup>44</sup> since, in the frequently used words of the ECJ:<sup>45</sup>

[f]reedom of establishment cannot [...] be understood as meaning that a Member State is required to draw up its tax rules on the basis of those in another Member State in order to ensure, in all circumstances, taxation which removes any disparities arising from national tax rules.

Accordingly, it should be determined, according to the tax rules of M/S P, if there is a “final loss”. This implies that if M/S P has a five-year carry-forward term for loss compensation, while M/S S has an unlimited carry-forward term, a six-year old loss of the subsidiary should still be regarded as a “final loss”. In addition, the tax rules of M/S P should also be applied in calculating the amount of the subsidiary’s “final loss”.<sup>46</sup>

## 6. Cross-Border Restructuring Operations

### 6.1. Introduction

Multinational companies may engage in various types of cross-border restructuring operations, for example, those listed in articles 2(a)–2(e) and article 2(k) of the Merger

Directive (2009/133).<sup>47</sup> In regard to each type of restructuring operation, a taxpayer may be faced with an exhaustion of losses, either legally or factually, in one or more jurisdictions. Potentially, the impossibility of utilizing the exhausted losses will hamper the realization of commercially desirable restructuring. This explains why carry-over of losses has been explicitly dealt with in article 6 of the Merger Directive, which stipulates that:<sup>48</sup>

[t]o the extent that, if the operations referred to in Article 1, paragraph a, [of the Merger Directive] were effected between companies from the Member State of the transferring company, the Member State would apply provisions allowing the receiving company to take over the losses of the transferring company which had not yet been exhausted for tax purposes, it shall extend those provisions to cover the takeover of such losses by the receiving company’s permanent establishments situated within its territory.

There are several limitations attached to the possibility of loss relief pursuant to article 6 of the Merger Directive (2009/133).<sup>49</sup> In the first place, the domestic law of the Member State of the transferring company should allow a receiving company to take over the non-exhausted losses of a transferring company in a purely domestic situation.<sup>50</sup> This is problematic, for instance, in Germany, where the possibility to carry over losses to a receiving company was abolished due to fears of the budgetary implications of *Marks & Spencer*. As the right of a receiving company to take over a transferring company’s losses in the context of a domestic merger has been disallowed, Germany can rightly argue that it should also not be compelled to allow for the compensation of losses of a non-resident transferring company.<sup>51</sup> According to Breuninger (2006),<sup>52</sup> however, there is no end to the matter since, in a purely domestic situation, companies would still have been able

41. *HMRC v. Marks & Spencer* (2011), paras. 87–88.

42. AG Opinion in *A Oy* (C-123/11), paras. 73–75.

43. See, inter alia, NL: ECJ, 29 Nov. 2011, Case C-371/10, *National Grid Indus BV v. Inspecteur van de Belastingdienst Rijnmond/kantoor Rotterdam*, para. 62, ECJ Case Law IBFD.

44. DE: ECJ, 26 Oct. 1999, Case C-294/97, *Eurowings Luftverkehr AG v. Finanzamt Dortmund-Unna*, para. 46, ECJ Case Law IBFD.

45. *Deutsche Shell* (C-293/06).

46. *HMRC v. Marks & Spencer* (2011), para. 76.

47. EU Merger Directive (2009): Council Directive 2009/133/EC of 19 October 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 (Codified Version), OJ L310 (2009), EU Law IBFD.

48. For an excellent discussion of the treatment of losses under the Merger Directive, see J. Bezzina, *The Treatment of Losses under the EC Merger Directive 1990*, 42 Eur. Taxn. 2, pp. 57–71 (2002), Journals IBFD.

49. J. Calleja Borg sees several other limitations on the possibility of loss relief pursuant to article 6 of the Merger Directive (2009/133), such as: (1) the absence of a definition of “losses”, (2) the lack of rules if only a portion of the transferring company’s losses can be carried over to the (PE of the) receiving company, and (3) the lack of clear indications as to what “valid commercial reasons” entail within the meaning of article 15 of the Merger Directive. See J. Calleja Borg, *Non-exhausted Losses and the Merger Directive: What It Fails to Say*, Intertax 11, pp. 557–563 (2011).

50. See also Commission of the European Communities, Commission Staff Working Paper, *Company Taxation in the Internal Market*, COM(2001)582 final, 23 Oct. 2001, p. 296, EU law IBFD: “[u]sually national legislation either forbids the losses of the acquired company to be transferred to the acquiring company or only allows this to be undertaken subject to a number of restrictions. The fact that deferrable losses cannot be transferred from the acquired company to the acquiring company is clearly an impediment to restructuring operations. It means companies are more likely to abandon or defer any restructuring operations they might have planned and thus negatively influences the competitive status of EU business”.

51. See J. Englisch, *Reform of the Reorganization Tax Act and Related Changes*, 47 Eur. Taxn. 7, pp. 342–343 (2007).

52. G.E. Breuninger, *Restructuring and Reorganizing the European Group, German Tax Law Aspects*, available at <http://meetings.abanet.org/meeting/tax/ROME06/media/Breuninger.pdf>.

to offset losses under the German “*Organschaft*” rules<sup>53</sup> and furthermore, the impossibility of carrying over losses still constitutes a restriction on a “particular method of exercise of the freedom of establishment”.<sup>54</sup>

In the second place, article 6 of the Merger Directive (2009/133) is silent on (1) whether the Member State of the receiving company should take into account the losses of the transferring company and (2) whether the Member State of a transferring company should accept the compensation of the losses incurred in the Member State of the receiving company. One could infer from *Lidl Belgium* that, in regard to “final losses”, the first question should be answered affirmatively, whereas *Futura* suggests a negative answer to the second question, since a PE state cannot be compelled to take into account losses incurred in the state of residence.<sup>55</sup>

In the third place, not only is the Merger Directive’s material scope limited to the restructuring operations listed in article 2, but its personal and territorial scope is also restricted by the requirement that companies from two or more Member States must be involved (article 1(a) in conjunction with article 3 of the Merger Directive). For situations outside its scope, the authors review in sections 6.2.–6.4. – by means of a number of examples – whether or not a taxpayer can invoke the freedom of establishment to avail itself of loss compensation. The examples are stylized in such a way that they fully reflect the difficulties of applying the “no possibilities” test.

## 6.2. Non-discriminatory tax obstacles

*Marks & Spencer* concerned the UK group relief rules. However, certain Member States do not provide for any type of group taxation regime.<sup>56</sup>

Assume that one of these Member States does not allow a resident parent company to take into account a “liquidation loss” where a subsidiary – either resident or non-resident – is liquidated. If the participation exemption applies to the income derived from the subsidiary, a loss on the shares in the subsidiary is generally not deductible either.

Accordingly, one cannot identify a difference in treatment between the liquidation of a resident subsidiary and a non-resident subsidiary. The question is, however, whether or not the freedom of establishment may compel M/S P to take into account a “liquidation loss” where a

53. We expect the ECJ to decide that disadvantages that arise out of the limitation of the German “*Organschaft*” regime to taxpayers earning German taxable income are justified by the need to safeguard the balanced allocation of taxing powers, in a similar way as in the *X Holding BV* decision. For an overview of German case law on the compatibility of the German “*Organschaft*” rules with the freedom of establishment, see A. Cordewener, *Cross-border loss relief and the “effet utile” of EU law*, EC Tax Rev. 2, p. 60, footnote 27 (2011).

54. DE: ECJ, 13 Dec. 2005, Case C-411/03, *SEVIC Systems Aktiengesellschaft v. Amtsgericht Neuwied*, para. 19, ECJ Case Law IBFD.

55. LU: ECJ, 15 May 1997, Case C-250/95, *Futura Participations SA and Singer v. Administration des contributions*, ECJ Case Law IBFD.

56. From a study conducted in 2011, it appears that 6 of the 27 Member States do not provide for any type of group taxation regime. See G.F. Boulogne, *Group Taxation within the European Union: Did Papillon and Art. 24(5) of the OECD Model Tax Convention Create a Butterfly Effect?*, 51 Eur. Taxn. 5, pp. 177-178 (2011), Journals IBFD.

non-resident (EU) subsidiary is liquidated, even though M/S P does not discriminate between resident and non-resident subsidiaries.

Turning to the ECJ’s direct taxation case law, it appears that it builds predominantly on a concept of discrimination.<sup>57</sup> However, the ECJ has also reiterated, in cases regarding direct taxation, that the free movement provisions require the “abolition of any restriction, even if it applies without distinction [...], when it is liable to prohibit or otherwise impede” a cross-border activity.<sup>58</sup> Hence, the identification of a discriminatory element does not seem to be a prerequisite for establishing a restriction on the freedom of establishment. As holding 100% of the shares in a non-resident (EU) subsidiary is an activity that falls within the scope of the freedom of establishment,<sup>59</sup> the impossibility of a parent company taking into account a loss upon the liquidation of its subsidiary can be viewed as an obstacle to the parent company’s freedom of establishment. Subsequently, one could argue that a “liquidation loss” of a non-resident (EU) subsidiary should be deductible in M/S P since it constitutes a “final loss”.

Two issues should be distinguished here: (1) can the parent company take into account the operational losses incurred by the subsidiary and (2) can the parent company deduct the loss on the shares in the subsidiary? It emerges from the *Rewe* (Case C-347/04) case that the ECJ differentiates between both categories of losses.<sup>60</sup> Regarding the first issue: taxing the parent company as an autonomous entity, hence disregarding the results of its subsidiary, is a legitimate means of exercising fiscal jurisdiction by M/S P. M/S P’s fiscal sovereignty would be eroded too severely if the freedom of establishment were to imply that M/S P would be forced to abandon this system. Concerning the second issue, here the loss on the shares in the subsidiary is exempt under the participation exemption rules. By exempting these losses (i.e. they become non-deductible), M/S P is introducing a rule that, although applying in a non-discriminatory manner, still restricts cross-border establishment. In this situation, the freedom of establishment could outweigh M/S P’s fiscal sovereignty and could compel that Member State to allow the parent company to deduct the loss on its shareholding. In this situation, the balanced allocation of taxing powers between M/S P and

57. On non-discriminatory tax obstacles and direct taxation, see S.C.W. Douma, *Non-discriminatory tax obstacles to free movement*, in *Europäisches Steuerrecht – Festschrift für Friedrich Rödler zum 60. Geburtstag* pp. 193-203 (Linde Verlag 2010).

58. See, inter alia, *Deutsche Shell* (C-293/06), para. 28 and *National Grid Indus* (C-371/10), para. 36.

59. In NL: ECJ, 7 Sep. 2006, Case C-470/04, *N v. Inspecteur van de Belastingdienst Oost/kantoor Almelo*, para. 30, ECJ Case Law IBFD, the ECJ held that: “a Community national, such as the applicant in the main proceedings, who has been living in one Member State since the transfer of his residence and who holds all the shares of companies established in another Member State, may rely on Article 43 EC”.

60. DE: ECJ, 29 Mar. 2007, Case C-347/04, *Rewe Zentralfinanz eG v. Finanzamt Köln-Mitte*, para. 48, ECJ Case Law IBFD: “[t]he losses at issue in the main proceedings are incurred by the parent company because of the reduction in the book value of its shareholdings subsidiaries. Those losses related to the writing down of the book value of the shareholdings are taken into account only as regards the parent company and are subject, for tax purposes, to a different treatment from that which applies to losses incurred by the subsidiaries themselves”.

M/S S is not at stake: the loss on the shareholding is – by nature – only “visible” in M/S P.<sup>61</sup>

### 6.3. “Change of ownership” rules

Various Member States have “change of ownership” rules that trigger the forfeiture of (a part of) a subsidiary’s losses upon a significant change of its ownership.<sup>62</sup> Generally, these rules seek to prevent trading in loss-making companies.<sup>63</sup> As an example, if Company A SA, resident in Member State X, acquires all the shares in Netherlands resident company B BV, the losses of B BV may be forfeited under the Netherlands tax rules.<sup>64</sup>

As the acquisition of a 100% shareholding in another Member State is an act of (secondary) establishment, one could argue that the Netherlands “change of ownership” rules are in breach of the freedom of establishment, as they make the establishment of A SA in the Netherlands less attractive.<sup>65</sup> As the rules do not distinguish between resident and non-resident shareholders, they may, as in the example in section 5.2. above, constitute a non-discriminatory obstacle to the freedom of establishment. Absent a sufficient justification for this restriction, the Netherlands might be compelled to allow for the compensation of the pre-“change of ownership”-losses against B BV’s future profits.

An extra dimension is added to this analysis if, under the group taxation regime in Member State X, losses of a qualifying resident subsidiary can be offset “horizontally” against a resident parent company’s profits.<sup>66</sup> Assume that the group taxation regime is only open to resident companies or non-resident companies that carry on business in Member State X through a PE. What arises is arguably a *Marks & Spencer*-type situation: M/S P has a discriminatory group taxation regime and losses have become legally exhausted in M/S S. In the authors’ view, it follows from *Krankenheim Wannsee* that M/S P should only be obliged to allow for a deduction of the losses incurred in M/S S if these losses also qualify as “final losses” according to the tax rules of M/S P. This is the situation if M/S P also has its own “change of ownership” rules in place. A relevant question here is: does the obligation imposed on M/S S to

allow for compensation of the pre-“change of ownership”-losses affect, in M/S P, the characterization of these losses as “final losses”? In this regard, it seems to follow from the ECJ’s earlier case law that the (possible) non-compliance of EU law by one Member State (M/S S) cannot be brought forward by another Member State (M/S P) as an argument for being less diligent in complying with its own EU obligations.<sup>67</sup>

### 6.4. Losses and transfers of seat

The restructuring operations covered by the Merger Directive (2009/133) include transfers of a registered office of SEs and SCEs from one Member State to another.<sup>68</sup> In regard to such operations, article 10c(2) of the Merger Directive contains a special provision on the carry-over of losses:

[t]o the extent that a company transferring its registered office within the territory of a Member State would be allowed to carry forward or carry back losses which had not been exhausted for tax purposes, that Member State shall allow the permanent establishment, situated within its territory, of the SE or of the SCE transferring its registered office, to take over those losses of the SE or SCE which have not been exhausted for tax purposes, provided that the loss carry forward or carry back would have been available in comparable circumstances to a company which continued to have its registered office or which continued to be tax resident in that Member State.

Similar to the other loss carry-over provisions of the Merger Directive, article 10c(2) provides that losses of a company transferring its registered office can be carried over to a PE in the Member State of departure. A transfer of a company’s registered office, one type of a transfer of seat, is an act of establishment<sup>69</sup> that is not restricted to SEs and SCEs.<sup>70</sup> The questions arise (1) whether or not the host Member State may be obliged to allow for the compensation of “final losses” incurred in the Member State of departure and (2) conversely, whether or not the Member State of departure may be compelled to allow for the compensation of “final losses” incurred in the host Member State.<sup>71</sup>

Regarding the first question, one could think of a Netherlands resident company that transfers its place of effective management and all of its assets to Member State Y. Upon migration, tax losses remain outstanding in the Netherlands. If the company subsequently becomes profitable in Member State Y, can it offset (a part of) its profits realized in Member State Y against its outstanding Netherlands losses? In answering this question, it should first be established that the inability to use the outstanding

61. See *Rewe Zentralfinanz* (C-347/04) para. 43: “[h]owever, a difference in tax treatment between resident parent companies according to whether or not they have subsidiaries abroad cannot be justified merely by the fact that they have decided to carry on economic activities in another Member State, in which the State concerned cannot exercise its taxing powers. Accordingly, an argument based on the balanced allocation of the power to impose taxes between the Member States cannot in itself justify a Member State systematically refusing to grant a tax advantage to a resident parent company, on the grounds that that company has developed a cross-border economic activity which does not have the immediate result of generating tax revenues for that State”.

62. See, inter alia, W. Kessler & R. Eicke, *Losing the Losses – The New German Change-of-Ownership Rule*, Tax Notes Intl., pp. 1045-1048 (10 Dec. 2007).

63. See, D.R. Post & K.P.E. Stals, *The Tax Treatment of Corporate Losses: A Comparative Study*, Intertax 4, pp. 236-237 (2012).

64. See, inter alia, NL: Corporate Income Tax Act (*Wet op de vennootschapsbelasting 1969 – CITA*), art. 20a, National Legislation IBFD.

65. See S.C.W. Douma, *Non-discriminatory Tax Obstacles*, EC Tax Rev. 2, pp. 67-83 (2012).

66. The authors assume that losses incurred by a subsidiary prior to its inclusion in the group taxation regime can also be set off “horizontally” against the profits of other group members.

67. See, inter alia, LU: ECJ, 13 Nov. 1964, Joined Cases 90/63 and 91/63, *Commission of the European Economic Community v. Grand Duchy of Luxembourg and Kingdom of Belgium*.

68. See art. 1(b) in conjunction with art. 2(j) of the Merger Directive.

69. See, in pertinent part, para. 6 of the Preamble of the 2005 amending Directive: “[t]he transfer of the registered office of a company is a means of exercising freedom of establishment”.

70. See J.W. Bellingwout, *Cartesio: mijlpaal en doorbraak na Daily Mail*, Weekblad Fiscaal Recht 6800, pp. 217-227 (2009).

71. If one does not share the authors’ view that these “factually” exhausted losses would qualify as “final losses”, one could also think of the company’s “legally” exhausted losses, which are forfeited under article 20(2) of the CITA.

Netherlands losses constitutes an obstacle to the company's freedom of establishment. This is possible if one regards the impossibility to offset the profits realized in Member State Y against the Netherlands losses as an obstacle that diminishes the effectiveness of the company's freedom of establishment. Perhaps, one could also establish that there is discriminatory treatment here if a foreign company that becomes subject to corporate tax in Member State Y cannot offset its outstanding losses, whereas losses incurred by a sole proprietorship (subject to personal income tax in Member State Y) prior to its conversion to a company of Member State Y (subject to corporate income tax in Member State Y) can be offset effectively against the profits of that company. Turning to a possible justification for this restriction, the need to preserve a balanced allocation of taxing powers between the Netherlands and Member State Y can be put forward as a reason to generally deny the compensation of the Netherlands losses against the profits realized in Member State Y. Nonetheless, as the losses can be characterized as "final" – they can no longer be taken into account in the Netherlands due to the lack of a business activity carried on there – one could argue that the outstanding Netherlands losses should be deductible in Member State Y.

Concerning the second question, assume this time that the company does not have any Netherlands losses available for carry forward upon its migration. In contrast, at the time the company transfers its place of effective management to Member State Y, the amount of Netherlands tax is definitively established on the basis of a (deemed) capital gain (the company's assets contain hidden reserves). In line with *National Grid Indus*, this tax is not recovered until the capital gain incorporated into the assets is realized.<sup>72</sup> After arrival in Member State Y, however, the company engages in a downward spiral and fails to become profitable. Does this mean that the company's Netherlands tax liability is erased? In this regard, in *National Grid Indus*, the ECJ draws a clear dividing line between (1) the definitive establishment of the amount of tax and (2) the recovery of the tax.<sup>73</sup> Although, rationally, the profits incorporated into the assets will no longer be realized, the Netherlands tax may – in principle – remain outstanding.

Although the fact that it is impossible to offset the losses incurred in Member State Y against the Netherlands profits would constitute an obstacle to the company's freedom of establishment, the Netherlands could justify not taking into account the losses incurred in Member State Y by arguing that, under the "principle of territoriality linked to a temporal component",<sup>74</sup> it is entitled to tax profits that have accrued in its territory prior to the migration to Member State Y without taking into account subsequent decreases in value. In this regard, the ECJ explicitly held in *National Grid Indus* that:<sup>75</sup>

a possible omission by the host Member State to take account of decreases in value does not impose any obligation on the Mem-

ber State of origin to revalue, at the time of realisation of the asset concerned, a tax debt which was definitively determined at the time when the company in question, because of the transfer of its place of effective management, ceased to be subject to tax in the latter Member State.

Given the unambiguous wording used by the ECJ, it is questionable whether or not the Netherlands is compelled to take into account the losses incurred in Member State Y by forgiving the existing Netherlands tax debt. If the losses incurred in Member State Y can be offset against future profits in Member State Y, these losses cannot be regarded as "final losses". Accordingly, the "no possibilities" test cannot be invoked as an *ultima ratio* to set aside the general notion that the Member State of departure does not have to take into account subsequent decreases in value. If, however, the losses incurred in Member State Y do qualify as "final losses" (for example, because the company's activities in that Member State have ceased) it seems unsatisfactory that a domestic transfer of the company's place of management (no taxation of the capital gain incorporated into the assets) is treated more favourably than a cross-border transfer of the company's place of management (the capital gain incorporated into the assets would be taxed even though it never materializes).

## 7. Conclusions

The reach of the "no possibilities" test that was introduced in *Marks & Spencer* is still far from clear. Further litigation before national courts and the ECJ is, therefore, expected. In the *A Oy* case, the ECJ will have to answer the question of whether or not the "no possibilities" test can be invoked to set off a non-resident transferring company's losses against a receiving company's profits.

In the authors' view, one should bear in mind the nature of the "no possibilities" test: which is an application of the principle of proportionality "*stricto sensu*". In the context of cross-border loss compensation, this means a balancing act between (1) the legitimate objective of preserving a balanced allocation of taxing powers and (2) the gravity of the restriction of the freedom of establishment. In this light, the authors argue that both *legal* and *factual* exhaustion of the possibilities of loss utilization may trigger "final losses", which should be deductible in another Member State. In calculating a subsidiary's "final losses", the authors believe that the tax rules of M/S P should be applied.

An outstanding question is whether or not non-discriminatory tax measures can compel a Member State to allow for the compensation of "final losses" incurred in another Member State. For instance, if the Member State of a parent company does not offer the possibility to take into account a "liquidation loss" upon the liquidation of a *resident* subsidiary, should it be obliged to do so under the "no possibilities" test where a *non-resident* subsidiary is liquidated? This matter is also relevant in regard

72. *National Grid Indus* (C-371/10), para. 65.

73. *National Grid Indus* (C-371/10), para. 86.

74. *National Grid Indus* (C-371/10), para. 60.

75. *National Grid Indus* (C-371/10), para. 61.

to loss compensation forfeited under “change of ownership” rules or a transfer of losses outside the scope of articles 6 and 10c(2) of the Merger Directive (2009/133). Finally, an open issue is whether or not the obligation to take into account “final losses”

may run counter to the ECJ’s stance in *National Grid Indus* that the Member State of departure is not required to take into account decreases in value arising in the host Member State.

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