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Opinion Statement ECJ-TF 3/2013 of the CFE

on the case A Oy (C-123/11)

and the use of cross-border losses

Prepared by the ECJ Task Force of the CFE

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This is an Opinion Statement prepared by the ECJ Task Force[1] on A Oy (Case C-123/11).
The CFE is the leading European association of the tax profession with 33 national tax adviser organisations from 25 European countries representing over 180,000 tax advisers.
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1. This Opinion Statement analyses Case C-123/11 *A Oy*, concerning the possibility of using Swedish losses in Finland following a merger which made the losses unusable in Sweden.

I. The facts and the legal background

2. A was a Finnish company with a wholly owned subsidiary (B) which was resident in Sweden. After making trading losses amounting to SEK 44.8 million between 2001 and 2007, B closed its sales outlets but remained bound by two long-term leases. A intended subsequently to merge with B which would result in A no longer having a subsidiary or permanent establishment in Sweden; all of B's assets and liabilities would be acquired by A, and B would be dissolved. The leases would be transferred to A and the group structure would be simplified by the merger. The merger could be justified from an economic point of view.

3. The taxpayer applied to the Central Tax Board in Finland for advance clearance to deduct B's losses following the merger pursuant to the relevant Finnish rules. The Board refused to give clearance on the ground that the losses had been incurred under Swedish tax law and therefore could not fall within the Finnish provisions for deducting losses. A appealed this decision to the Supreme Administrative Court, which made a reference to the Court of Justice to determine whether the Finnish rules on deductibility of losses were contrary to the freedom of establishment and whether any restriction could be justified by overriding reasons of public interest, specifically the balanced allocation of taxing powers.

II. The preliminary questions and the decision

The questions

4. Two questions were referred by the national court for a preliminary ruling:

[1] Members of the Task Force are: Paul Farmer, Daniel Gutmann, Volker Heydt, Eric Kemmeren, Michael Lang, Franck Le Mentec, Pasquale Pistone, Albert Rädler†, Stella Raventos-Calvo (acting Chair), Isabelle Richelle, Friedrich Roedler, Kelly Stricklin-Coutinho and Georg Kofler. Although the Opinion Statement has been drafted by the ECJ Task Force, its content does not necessarily reflect the position of all members of the group.

The first was whether Articles 49 and 54 TFEU meant that, following a merger, a taxpayer could deduct losses incurred by the merged company in another Member State, even though the taxpayer had no permanent establishment in that Member State, in circumstances where under national law the taxpayer could only deduct losses if the merged company was resident or the losses arose in a permanent establishment situated in that State.

The second question related to the methodology for quantifying loss relief, in particular, whether deductions should be calculated in accordance with the tax laws in the taxpayer's or the merged company's State of residence.

Advocate General Kokott's Opinion

5. In her Opinion of 19 July 2012 Advocate General Kokott took the view that case law had developed since *Marks & Spencer* to the extent that it was no longer relevant to consider whether losses incurred by B were capable of local use when considering whether an infringement of the freedom of establishment was justified[2]. The reason for this was that the Court had given increasing priority to the justification based on the balanced allocation of taxing powers over the other justifications mentioned in *Marks & Spencer,* such as the prevention of double use of losses, itself not an automatic justification; the paragraph 55 exception (there being no possibility of using the losses in the Member State in which they were incurred) was therefore no longer applicable. In other words, Advocate General Kokott considered that paragraphs 55 and 56 of *Marks & Spencer* had been implicitly overturned by the *X Holding* and *National Grid Indus* judgments[3].

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[2] Paragraph 55 of the *Marks &Spencer* judgment (C446/03) reads:

> "In that regard, the Court considers that the restrictive measure at issue in the main proceedings goes beyond what is necessary to attain the essential part of the objectives pursued where:
> – 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."

[3] Judgments *X Holding* of 25.2.2010 (C-337/08) and *National Grid Indus* of 29.11.2011 (C-371/10)

6. Advocate General Kokott nonetheless considered in the alternative whether the principles laid down in *Marks & Spencer* applied in the circumstances of the case. The possibility of using the losses had to be considered as the result of the choice to transfer the business from B to A. Additionally, Advocate General Kokott thought that, even where subsidiaries were loss-making and decided to cease trading, there was a possibility of using any losses by recommencing trading.

7. According to Advocate General Kokott, the inability to use the losses was simply the result of a free decision of the company to undertake the merger. This would be the consequence of the taxpayer choosing to merge and using the Swedish losses in Finland. The taxpayer could not be allowed to choose freely the tax scheme applicable to the losses and the place where the losses were taken into account. As a consequence, Advocate General Kokott concluded that neither the Tax Merger Directive nor Articles 49 and 54 TFEU preclude a national measure which does not allow the tax deduction, by a domestic company, of losses of a company of another Member State which has merged with it, where the activity of the foreign company was subject exclusively to the right of taxation of that other Member State.

The Court's decision

8. In its judgment of 21 February 2013 the Court implicitly rejected both Advocate General Kokott's principal conclusion that the *Marks & Spencer* caveat was no longer good law as well as her alternative conclusion that the merger involved a free choice which precluded a cross-border group relief claim.[4]

9. Instead, the Court simply applied the principles set out in *Marks & Spencer* to a merger scenario (under Finnish law) without a PE (Permanent Establishment) remaining in the country of the absorbed company. It considered in turn the three justifications referred to in *Marks & Spencer*, namely safeguarding the balanced allocation of taxing powers, avoiding double use of losses and preventing tax avoidance, and concluded, as in *Marks & Spencer*, that the legislation was justified in principle on these three grounds (paragraphs 40 to 46).

10. Then it went on to consider the proportionality of the restriction first as regards the difference in respect of the fact pattern of the *X Holding* case, by stating that a cross-border

[4] This apparent difference in approach has triggered Advocate General Mengozzi in his opinion of 21 March 2013 (case C-322/11 – K) to request the Court to clarify the issue.

merger does not give rise to a scenario where the parent company would be free to choose from one year to the next the tax regime of its subsidiaries [5]; second the Court addressed the proportionality of the restriction in relation to the three justifications (paragraphs 48 to 55), concluding that it went beyond what was necessary, where there was no possibility of using the losses in the Member State in which they were incurred.

11. It was for the national court to decide on the facts whether the possibility of using the losses in Sweden did in fact exist. If the national court found that the possibility of using the losses had been exhausted, the freedom of establishment would be unjustifiably breached by the Finnish tax law in question.

12. In relation to the calculation of losses, the Court, like Advocate General Kokott, was unable to provide a definitive answer. Any such calculation had to be subject to the specific facts of any particular case. The Court held that the methodology used must ensure that there is not unequal treatment in relation to cross-border group relief when compared with domestic group relief.

III. COMMENTS

The judgment is significant for a number of reasons.

13. First, the Court noted that the mere fact that a merger was tax motivated did not prevent reliance on Article 49 TFEU. This is consistent with previous case law[6]. The Court did however make the point that on the facts at hand the merger in question was economically justified.

14. The Court did not adopt the narrow interpretation of the *Marks & Spencer* ruling advocated by Advocate General Kokott. Contrary to the view taken by Advocate General Kokott, the fact that the company exercised a free choice in undertaking the merger did not preclude the grant of relief. The sole issue was whether the taxpayer could show on the facts in the specific case that it had exhausted all possibility of using the losses in Sweden.

[5] see. para 48 A Oy

[6] See e.g. judgments *Centros* of 9.3.1999 (C-212/97) and *SEVIC Systems* of 13.12.2005 (C-411/03)

15. The outcome of the ECJ case law is that business losses are to be deducted where a direct link with the economic activity exists, unless the losses are final. However, it still remains difficult to understand with exact certainty when a loss is to be considered final from the perspective of EU fundamental freedoms in the light of ECJ case law following *Marks & Spencer*. For instance, in the *Krankenheim am Wannsee* judgment[7] the ECJ endorsed the recapture of PE losses by the head office State even if they could not be taken into account in the PE State. In the *X Holding* judgment the ECJ did not specifically address the issue of final losses. As some national governments pointed out in this specific case, the final nature of losses could be questioned by taking into account some factual elements, such as for instance the right of the Swedish absorbed company to receive income out of the long-term lease of its business premises, or legal elements, such as the possibility to carry losses back under Swedish law. This shows the complexity of defining the category of final losses, which appears to be at the intersection between its concept under European Union law and facts (i.e. fact and national law finding) that are to be ascertained by the national Court. Despite such difficulty, we believe that the national courts of the Member States may still need more guidance with a view to achieving homogeneous guidance on what the EU law concept of final losses really means.

16. Another legacy of *Marks & Spencer* addressed by the Court in this judgment relates to the relevance of bundled or single justifications. As *in Marks & Spencer*, in this judgment the Court bundles three justifications together, namely (i) the balanced allocation of taxing powers, (ii) the risk of losses being taken into account twice and (iii) the risk of tax avoidance[8]. However, in other judgments the ECJ held two or only one of them to be sufficient to justify a different treatment. The issue may thus arise as to how this judgment should be understood in relation to the judgments that were handed down after *Marks & Spencer*. Three possible views may be held in this respect. First, a justification always requires the three grounds to be bundled together in the context of cross-border losses. Second, in this and in the *Marks & Spencer* judgment three justifications were brought up and the Court had no concerns in accepting all of them in such form. Third, the relevance of the three justifications bundled together arises were the context so requires, such as in this

[7] judgment *Krankenheim am Wannsee* of 23.10.2008 (C-157/07)

[8] *Marks & Spencer*, Paras. 43 to 46

and in the *Marks & Spencer* case. The latter two views may imply that two justifications or even one could still be sufficient in some instances.

17. Thus the Court was unwilling to extend the principle that taxpayers should be prevented from choosing the Member State in which to obtain relief for losses into a broader principle barring taxpayers from undertaking any act which rendered the loss unusable in the country of the loss-making company. Such an approach seems consistent with the underlying rationale of *Marks & Spencer.* A key concern for the Court has been to prevent taxpayers from jurisdiction-shopping for the relief of losses or, as Advocate General Poiares Maduro called it in *Marks & Spencer*, loss-trafficking. In the Court's eyes allowing such behaviour would be liable to undermine the balanced allocation of taxing powers. It is for that reason that the Court insists that the losses should not be capable of local use before they can be used in another Member State. It does not follow from that rationale however that a taxpayer should be unable to take any steps, such as a merger, whose effect is to render the losses unusable under local tax law.

18. On quantification the Court was evidently reluctant to be drawn into detail on the question of how to compute the losses available for set–off. The Court's remarks might be taken as suggesting that the unused losses should be computed according to the rules of the home country. However, this issue is a complex one on which the Court missed the opportunity to give further guidance. The United Kingdom courts have, for example, so far taken the view that the unutilised losses are to be determined under local principles and then converted to home state principles.

IV. The Statement

19. The CFE notes that the judgment appears to reaffirm the approach taken in the *Marks & Spencer* judgment. It would, however, be useful to get further clarification as to whether the justifications for the refusal of the use of final cross-border losses may be applied on a stand-alone basis or whether they need to be bundled. The forthcoming judgment in case C-322/11 (*K*) could be an early opportunity for clarification, as Advocate General Mengozzi has also suggested in his opinion of 21 March 2013 in that case.

20. The CFE would have expected the Court, without embarking on a calculation itself, to give an answer under EU law on the question of the tax rules of which Member State the losses have to be calculated.