Group Tax Planning

Tax Planning International: Special Report

May 2008

Group Tax Planning

In a global economy companies look to invest in foreign countries, and doing so in a tax efficient manner is one of the key drivers in investment decisions. How Groups of Companies within a multinational organisation are structured to minimise the overall tax burden is one of the most important concepts in international tax planning. The recently announced relocations of Shire plc and United Business Media from the UK to Ireland is just the latest example of Group Tax Planning in practice.

This Special Report focuses on Group Tax Planning from a European perspective. Articles focus on fundamental topics such inward and outward investment, taxation of foreign profits, cross border group relief (post *Marks & Spencer*), real estate finance structuring, financial flows in the light of the new Common Consolidated Corporate Tax Base, and moving and managing IP tax effectively.

Key holding jurisdictions such as Luxembourg and Cyprus are examined in detail, as well as major trading nations such as Germany, the UK, the Netherlands, France, Denmark and Austria.

Senior Commissioning Editor: Stephen Mullaly

Group Tax Planning is published by BNA International Inc., a subsidiary of The Bureau of National Affairs, Inc., Arlington, VA, U.S.A.

Administrative Headquarters: BNA International Inc., 29th Floor, Millbank Tower, 21-24 Millbank , London, SW1P 4QP, U.K.; tel. +44 (0)20 7559 4801; fax. +44 (0)20 7559 4840; e-mail: marketing@bnai.com; website: www.bnai.com

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Group Tax Planning forms part of BNAI's *Tax Planning International: Special Reports*, a series of Reports focusing on key topics in international tax.

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Partner, Dorsey & Whitney, London, and former Head of Tax Policy for the European Commission, Brussels.

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Dorsey & Whitney, London

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Introduction

Cross-border Group Relief Post *Marks & Spencer*

Simon Whitehead
Dorsey & Whitney, London

It is over two years now since the European Court offered its views in *C-446/03 Marks and Spencer v Halsey* on the question of whether group relief should be available between companies within the same group resident in different EU Member States. While it might be a little unkind to describe the Court's answer as "sometimes" or perhaps even "maybe", the ruling has certainly produced differences of opinion between the Court's own Advocates General on its application and difficult questions of interpretation for national Courts.

We know from the judgment in *Marks and Spencer* of course that national systems which restrict the availability of group relief to the surrender of only domestic losses pursue a justifiable objective. We know too that that objective is three-fold. By such a restriction the allocation of taxing powers between Member States is preserved, the multiple use of the same losses is avoided and "loss shopping" – the concept that groups will plan to make losses in low tax jurisdictions and surrender them to offset profits in high tax jurisdictions – will be prevented. Finally we are told by the Court that while pursuing that legitimate objective the UK's rules went too far by preventing the cross border surrender of losses even in circumstances where they could not be used in the local jurisdiction where they were incurred.

For those expecting a decisive answer, one way or the other, from the Court on whether community rights required the surrender of losses within a group across community borders, the Court's proportionality approach to the issue was distinctly unsatisfying. It immediately threw up numerous sub issues. The most obvious is perhaps the question of when losses meet the conditions laid down in the *Marks and Spencer* case to be eligible for cross border surrender. Secondly, is *Marks and Spencer* only relevant to group relief provisions? Or do its principles apply to other legislative mechanisms which permit the utilisation of losses within a group such as group contributions, fiscal unities or consolidations?

Thirdly, are the possibilities of surrender restricted to the group structure present in *Marks and Spencer*? In that case subsidiaries sought to surrender losses to offset profits of the parent company in the same accounting period. Considering the community right being invoked was the freedom of the parent to establish subsidiaries in other Member States, would the answer be any different if the transaction was, say, a surrender between two subsidiaries of a common parent located in different Member States?

Even more fundamentally, will losses only be available for cross border surrender when they meet the circumstances in *Marks & Spencer*, namely, where the loss maker has no possibility of using the losses in its jurisdiction? Or are the circumstances of the *Marks and Spencer* case merely one instance where the denial of group relief between group members in different EU Member States will infringe community law?

The *Marks and Spencer* case throws up many other issues besides.[1] In this article we will concentrate on these four key questions and consider developments since that ruling to investigate whether we are any closer to establishing when and how companies within a group should be able to surrender losses cross border within the community.

I. "No Possibility of Use"

Before we seek to offer some answers, let's start at the beginning. Finding consistency within the European Court's case law on direct taxation is a task best left to its Advocates General and esteemed academics.[2] Yet whether or not it sits easily within community jurisprudence, one would have thought that well established precedent for the Court's approach in *Marks and Spencer* is more easily located. In *C-279/93 Schumaker* the Court addressed the issue of where personal allowances should be given against the income tax liabilities of a person residing in one Member State but earning that income in another. The conclusion reached was that while it should be the state of residence which, being best placed to do so, should take into account the personal circumstances of the taxpayer by allowances against his or her tax liabilities if that

person made insufficient income in that state to enable those allowances to have an effect, the burden shifted to the state where the income was earned.

On the face of it, the approach of the Court in *Marks and Spencer* seems to borrow for a similar corporate tax purpose this principle established in a personal tax context. Both *Schumaker* and *Marks and Spencer* concern the availability of deductions against profits earned and taxed in another Member State. The conclusion in each is that those deductions should be taken into account in the jurisdiction to which they best relate. In *Schumaker* it is the State of the individual's residence which is best place to take into account his/her personal and family circumstances. In *Marks and Spencer* it is the State of residence of the loss making subsidiary which should account for the losses. Only where it is not possible for that State to take those deductions into account can and should they be accounted for elsewhere. By equating a multinational company group with a natural person working in several different Member States, the *Marks and Spencer* case begins to look a lot like a corporate adaptation of the venerable *Schumaker* principle. If so the case law arising from *Schumaker* may help us to understand how to apply *Marks and Spencer*.

The most recent outing of the *Schumaker* principle in the context of personal allowances was in 2004 in *C-169/03 Wallentin.* There a German theology student received certain income in Germany which was tax exempt while money he earned from a work experience placement in Sweden was subject to Swedish tax without deduction for personal allowances. Had Mr Wallentin been entitled to personal allowances in Sweden that income would have been exempt from Swedish tax as well.

Applying *Schumaker*, Sweden would only be required to make deductions for personal allowances if Mr Wallentin had been unable to benefit from personal allowances in his state of residence, Germany. At first glance one might be mistaken for thinking that Mr Wallentin had so benefited in Germany. His German income was tax exempt. Surely exempting income from tax is more beneficial than taxing it with deduction for personal allowances? That is however not the conclusion the Court reached. It was precisely because the income was tax exempt in Germany that his personal circumstances were not taken into account in establishing his taxable income there. Sweden was therefore required to allow deduction for personal allowances which were, on the facts, not taken into account in Germany.[3]

Whatever else the *Marks and Spencer* case might conclude, it tells us that losses should be available for surrender cross border to offset profits of the parent company when "…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 … and there is no possibility for the foreign subsidiary's losses to be taken into account in its State of residence for future periods….."[4]

Two schools of thought have formed concerning when a loss might be beyond future possible use. One sees the loss as only beyond possible use when a legal bar prevents it from being carried forward in that jurisdiction. This would arise for instance where local law imposed a time limit on how long a loss can be carried forward, or followed a schedular system and regarded losses as extinguished when a trade ceased or the loss making subsidiary was liquidated. The other sees the loss as beyond possible use when viewed on the basis of the objective facts of the loss maker itself.

The point where these lines of thought diverge is easiest seen in the following example. Assume a French subsidiary which is trading through two divisions one in Paris and the other in Lille. The Paris operation produces every year without fail profits of €1 million and will continue to do so in perpetuity. The Lille branch suffers a catastrophic loss of €1 billion. Can the losses be surrendered to the UK parent? Under the "legal bar" theory it could not. There would still be a possibility to use the losses in France even though it would take a thousand years to do so. Under the alternative "practical" test arguably it could – in reality the French subsidiary is never going to be able to use the vast majority of the losses.

The latest word in the UK on this issue is the judgment of the Court of Appeal in the *Marks and Spencer* case itself.[5] In their view losses will be beyond use when there is no real possibility of use in the objective circumstances of the local company. How in fact that understanding should be applied to the circumstances of Marks and Spencer has been left for the Special Commissioners to determine.

A further perspective is however offered when viewed through the prism supplied by the *Schumaker* principle. As we saw, Mr Wallentin was not required to show that at German law there was some legal bar prohibiting the application of personal allowances to his circumstances. The assessment was purely practical. In his particular case he received no allowances not because he earned insufficient income in Germany but because in his case the source of that income (funding from his parents and the State) rendered it exempt from German tax. If the *Marks and Spencer* case can find its genesis in the *Schumaker* principle therefore it should logically follow that a practical test applies to establish whether a loss should be beyond possible use. On this view, in the example given then the French subsidiary should be permitted to surrender its losses to the UK parent without closing its Paris branch. Exactly the point at which the French losses became beyond possible use should be established by compliant national provisions. This is precisely the position advocated by the EC Commission in its proposed Directive from 1991[6] on cross border losses and its recent Working Paper of December 2006[7] on the same topic both suggesting a six year claw back period.

II. Group Contribution Systems

Turning to the second area, applying *Marks and Spencer* from the context of group relief to group contribution has itself produced yet further sub issues. In a group relief system the loss-maker surrenders the loss to the profit-making company within the group to offset against its profits. Once surrendered the loss-maker can no longer carry forward the loss. In a group contribution system the process is reversed. The profit-maker contributes cash to the loss-maker which is deductible in the hands of the profit-maker and creditable at the other end. One would have thought the different approaches achieved in the broadest terms the same outcome enabling a company group to be taxed on its aggregated results. Should therefore the refusal of national group contribution systems to permit cross border group contribution payments be viewed in the same way as the like restriction within group relief systems?

The Court addressed the question in *C-231/05 Oy AA* which concerned an attempt to obtain a deduction in Finland for a group contribution payment paid by a Finnish subsidiary to its UK parent prevented by the restriction in the Finnish rules which limited deductions to contributions made within the

Finnish group. Here however the Court found against the taxpayer seemingly without the need to consider circumstances where the loss was beyond local use.

This apparent contrary position to *Marks and Spencer* is open to numerous interpretations.[8] One is that the Court may be resiling from its position in *Marks and Spencer* although there are no other signs that this is the case. Another might be the existence of divergent views among the judges yet while the Judge Rapporteur and Advocate General differed, the cases shared eight of their 13 judges in common. Yet another is that there are material differences between group relief and contribution systems. In the former the loss must be matched with a profit in the same accounting period. In group contribution systems that is not the case and indeed there is no obligation that there be a corresponding loss at all (although practically that is the reason for the contribution). Also the prospect arose that if the contribution payment was deductible in the hands of the profit-maker but not taxed in the recipient jurisdiction, the profits would end up free from tax at both ends, a point emphasised by the EC Commission as explaining their contrary position in *Oy AA* to that adopted by them in *Marks and Spencer*. Yet although these differences were highlighted during the hearing, they are not mentioned in the judgment as explaining any different approach.

A further possible explanation for the difference is that Marks and Spencer was not considered because in *Oy AA* there was no suggestion that the recipient's losses were beyond possible use. This seems the explanation preferred by the Swedish Advance Rulings Board[9] which recently held that, notwithstanding the *Oy AA* decision, deduction from the taxable profits of the contributor of group contribution payments made cross border should be available where the foreign loss is beyond possible use in the recipient jurisdiction.

III. Surrendering Losses between Subsidiaries

The third issue to consider then is whether the *Marks and Spencer* case is to be restricted only to circumstances where the loss is surrendered to the parent rather than between subsidiaries in different Member States. The UK in its amendments to the group relief provisions in section 27 and Schedule 1 of Finance Act 2006 ostensibly to take account of the ruling expressly certainly limits the application of *Marks and Spencer*, among other ways, to situations where the UK is the state of the parent. Thus the surrender of a loss cross border is theoretically possible (if all other conditions in the legislation are met) where the UK recipient company is the parent or a subsidiary of a UK parent of the non resident loss-maker.[10] The Commission's Working Paper on Tax Treatment of Losses in Cross-Border Situations (COM (2006) 824 final) also implies that surrenders need only be permitted to offset profits in the State of residence of the parent.

Whether this is however an overly restrictive reading of *Marks and Spencer* need not delay us as double tax conventions should provide as adequate answer whatever may be permitted by community law alone.

Commonly double tax conventions including those between Member States of the EU incorporate the standard OECD model non discrimination clause prohibiting (at article 24(5) of the model) enterprises of one contracting state (say the UK) whose capital is owned wholly or partly, directly or indirectly in the other (say France) from being subject to "other or more burdensome" taxation and connected requirements than other similar enterprises of that state (the UK). "Other similar enterprises" has now been interpreted by, it seems, all the national supreme courts within the EU who have considered it as requiring a comparison between the tax treatment of the local subsidiary of a non resident parent and that of the local subsidiary of a local parent company.[11]

With that in mind, consider what happens when a UK subsidiary is permitted to receive the surrender of a loss from a French subsidiary of a common UK parent, a situation even the UK government acknowledges is engaged by the *Marks and Spencer* ruling. In those circumstances the UK subsidiary is subject to less tax than it would be if the surrender was not permitted. Now substitute in that example a parent company resident in the United States, the Netherlands or another State whose double tax convention with the UK incorporates a standard non discrimination article. If that UK subsidiary is not entitled to receive the surrender it will be subject to a higher tax burden than a UK subsidiary of a UK parent for no other reason than that its capital is owned in the other contracting state. The conclusion seems inescapable that to restrict cross border group relief to circumstances where the parent is resident in the same Member State would offend these non discrimination obligations producing the same result as if community law permitted the direct surrender of losses between them.

IV. The Cashflow Issue

This takes us to our final question: is cross border group relief to be restricted only to circumstances of terminal losses or are such losses merely one example where the restriction of group relief to domestic situations can offend community law? Here we enter the ongoing debate between the Court's Advocates General concerning how far *Marks and Spencer* should be taken.

The late Advocate General Geelhoed could not see how the prospect of any circumstance at all in which the losses of one company within a group might be surrendered cross border to offset the profits of another could be shoe-horned, even exceptionally, into the approach he believed the Court should take in the area of direct taxation. It represented to him "an additional disparity in the interrelation between national tax systems" and created the potential for distorting the exercise of community rights.[12]

Advocate General Legér in contrast has been far less apocalyptic in his approach to the impact of *Marks and Spencer.* While AG Geelhoed believed that allowing surrenders even exceptionally threatened the community's legal order, for AG Legér it is the permission which that judgment might give to the denial of cross border group relief in the general case which seems difficult to rationalise with the Court's case law. To him a restriction on cross border group relief can only be justified where all three aspects of the objective identified in *Marks and Spencer* are present and then only to the minimum extent required to fulfill that purpose.[13] While companies cannot transfer losses from one State to another to suit their convenience this cannot call into question the scope of the freedom of establishment.

Into this melee AG Sharpston recently stepped with her opinion of February 14, 2008 in *Lidl Belgium.* The case concerns the repatriation of the losses of its Luxembourg branch in 1999 to offset profits of the company, Lidl Belgium GmbH, in Germany. The German-Luxembourg double tax convention exempted the profits of a Luxembourg branch from tax in Germany. If branch profits were exempt so too, the German Courts had concluded, branch losses could not be repatriated.

For a number of reasons this opinion has been eagerly anticipated. One was to see whether, at least at the level of Advocates General, a distinction could be drawn between branches and subsidiaries. While in *C-307/97 Saint Gobain* the Court had concluded that the freedom of establishment offered cross border transactors an unfettered choice in the form of establishment – so that tax provisions which favoured the establishment of a local subsidiary over a branch were incompatible with community law – in *Marks and Spencer* the different approach to use of the losses of a foreign branch as opposed to a non resident subsidiary appears not to have been thought overly relevant.

Another reason was an important difference from the facts in *Marks and Spencer* for in *Lidl Belgium* the losses of the branch were not beyond possible local use but had in fact been carried forward and utilised against branch profits in Luxembourg in subsequent years (paragraph 14 of the opinion). *Lidl Belgium* therefore stands as an opportunity for the Court to tell us whether cross border relief for losses is limited to the terminal circumstances of Marks and Spencer.

Of course it is accepted in the *Marks and Spencer* case itself that the ability to carry forward a loss is no substitute for group relief. Take the following example. The ABC group has two subsidiaries, Company A, in the UK and Company B, in another EU Member State. In Year One Company A made a profit of £100 and B a loss in the same amount. In Year Five Company B returns to profit sufficient to utilise the brought forward losses. If group relief was available no tax would be paid by the group in Year One. While Company B would pay tax in Year Five if the Year One loss had been surrendered rather than carried forward, the group would still receive a cashflow benefit in postponing the payment of tax for 5 years. The pre-mature payment of tax is as likely to offend community law as an excess payment.[14]

In her opinion in *Lidl Belgium* AG Sharpston draws no relevant distinction between branches and subsidiaries: "the ability to deduct losses of a foreign subsidiary by way of group relief is clearly analogous to the ability to deduct losses of a foreign permanent establishment" (paragraph 10). This therefore makes the *Marks and Spencer* judgment directly relevant. Most significant is her application of *Marks and Spencer* to the circumstances of a loss subsequently utilised in the local jurisdiction where it was incurred. In *Marks and Spencer* the Court was dealing with terminal losses (paragraph 27). Its judgment is therefore directed to those circumstances. The principles laid down however are also applicable where the loss was utilised subsequently, the group will still suffer a cash flow disadvantage if it cannot make use of the loss cross border in the same accounting period (paragraph 28):

"The Court is well aware of the significance of cash flow to undertakings. It has repeatedly held that the exclusion of a cash-flow advantage in a cross-border situation where it is available in an equivalent domestic situation is a restriction on the freedom of establishment. Indeed it made this very point forcefully in *Marks & Spencer*…." (paragraph 29)

In her opinion then the issue becomes simply could Germany have employed a less restrictive means to prevent the duplicate use of the loss than simply excluding it from repatriation? The answer is offered by the German legislative history itself as prior to 1999 Germany did indeed have provisions which permitted the deduction of foreign branch losses from the company's German profits with a recapture system if the losses were subsequently used locally (paragraph 24). It follows then that the denial of deduction of foreign branch losses breaches community law.

V. Where to Now?

By seeing as analogous the circumstances of repatriating foreign branch losses and surrendering the non resident losses of a foreign subsidiary there are obvious implications for cross border group relief. Certainly if AG Sharpston's opinion is followed by the Court it would give us greater simplicity in answering some of the other practical conundrums discussed above. Is a foreign loss beyond possible use if it will not be used in two years or five or ten? Arguably where there is a clear cashflow disadvantage deriving from the restriction prohibits the cross border surrender of losses so that non resident losses can only be carried forward in that jurisdiction, under AG Sharpston's view community law would be infringed. How do we compute the foreign losses available for surrender? AG Sharpston's approach would seem to suggest we look to how the group has been disadvantaged.

It is perhaps too much to ask that the Court simplify these difficult problems by following its Advocate General's lead in *Lidl Belgium.* We have seen that even where the Court appears to follow the lead of its Advocate General the reasoning, if it is even given, can still be quite different.[15] Yet given the forceful approach advocated by AG Sharpston it is difficult to see how the Court might side-step the issue.

Simon Whitehead *is a Partner in the London office of Dorsey & Whitney and may be contacted by email at: Whitehead.Simon@dorsey.com*

1 A particularly vexing question for instance concerns how the losses should be computed. If only losses unavailable for local use could be surrendered, doesn't this imply that the surrenderable losses are to be ascertained upon the rules of the jurisdiction where they arose? If so how can the losses then be reconciled with the recipient's profits computed in accordance with the rules in that jurisdiction? Let us leave the computational issues however for another occasion.

2 For a recent attempt see Denis Weber "In search of a (new) equilibrum between tax sovereignty and the freedom of movement within the EC". Kluwer-Deventer, 2006

3 C-169/03 *Wallentin* at paragraphs 17-20.

4 Paragraph 55

5 *Marks and Spencer v Halsey* 12007 All ER (D) 232.

6 OJ 1991, C53/30

7 COM (2006) 824 fin

8 The European Parliament resolution of January 15, 2008 on Tax Treatment of Losses in Cross-Border Situations (2007/2144(INI)) notes the anomaly indicating that "it is thus unclear if the losses can be consolidated within a group in all cross-border situations even when the losses are final and thus result in a disproportionate situation as indicated by the Marks and Spencer case" (paragraph 15 of the resolution).

9 Decision of January 28, 2008.

10 Sections 402(1)(b), (2) and (2A) of the Income and Corporation Taxes Act 1988.

11 For references to the decisions of the supreme courts in Sweden, Germany, France, the Netherlands, Finland and England and Wales and a more general discussion see S. Whitehead "Interpretation of Non-Discrimination Articles", The Tax Journal, June 4, 2007 at pp 9-11.

12 Paragraph 65 of his opinion in *C-374/04 Test Claimants in ACT Class IV.*

13 Paragraphs 94-105 of his opinion in C-196/04 Cadbury Schweppes

14 C-397/98 & 401/98 Metallgesellschaft and Hoechst; C-446/04 Test Claimants in the FII group Litigation; n.b. C-270/83 Comm v France.

15 N.b. the approach in *Cadbury Schweppes: see* "What's Your Motive?" *Taxation* September 21, 2006

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