

Cross-border loss utilisation



Australia

Cross-border loss utilisation – An Australian perspective

Following recent legislative tax reform, the Australian tax regime no longer imposes direct limitations (i.e. quarantining) on the ability for taxpayers to apply business losses generated in foreign jurisdictions against their Australian sourced income. However, the tax legislation provides controls by way of debt/equity rules, thin capitalisation rules and transfer pricing to ensure the integrity of the tax system so as to prevent revenue leakage from Australia in dealings with associated entities located offshore.

The Australian Taxation Office (ATO) has recently announced that, as part of its compliance programme, it will be focusing, amongst other things, on the following areas involving offshore based associated entities:

- Transfer pricing (profit and loss shifting within multinational groups).
- Cross-border transactions which increase debt or create double deductions in Australia and offshore.
- Thin capitalisation, with a particular focus on contrived arrangements that place high levels of debt into Australia.
- Restructures of Australian-based operations to alter the function profile on a non-arm's length basis, e.g. the creation and use of marketing hubs or the sale of the intellectual property at nominal prices.
- Paying excessive royalties, interest, guarantee or other fees.
- Australian headquartered entities providing services to overseas affiliates for non-arm's length consideration.
- Allocating to Australian businesses income and expenses not consistent with the functional profile of the business.

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australia

Kings Avenue Bridge
in Canberra

In announcing that it will be targeting international transactions, the ATO has observed that there is a significant concentration of cross-border activity in the large business segment which has intensified with the increasing internationalisation of the Australian economy and the globalisation of capital markets. In this regard the ATO has stepped up its exchange of information with other countries to assist in its compliance and tax risk management activities.

The ATO has also identified that approximately 40% of large businesses are foreign-owned and that there are various levels of foreign shareholder participation across the remaining 60%. There has also been a significant level of debt funding associated with this inbound investment and the proportion of debt funding has seen rapid increase since the year 2000 while the proportion of equity funding has been declining. These factors have brought cross-border financing sharply into focus for the ATO.

In view of these developments, the ATO will be increasing its audit activities to ensure proper arm's length methodologies are adopted in respect of cross-border transactions with associated entities and examination of such transactions will not be limited to recent business activities. In undertaking its enquiries the ATO has stated that it will be expecting full disclosure and cooperation from taxpayers (especially from company board directors) and will be resorting to harsher penalties in cases where this is not forthcoming.

In focusing on thin capitalisation compliance, the ATO has stated that it will take into account the impacts of the global financial and economic crisis given the fact that asset values have been adversely affected in many cases.

Although the ATO has been specifically targeting domestic loss claims as part of its ongoing compliance strategy for some time, the availability of foreign losses are also subject to the same deductibility tests that apply to domestic losses and so one can expect the same close scrutiny for such losses to ensure they comply with the law.

Needless to say, record keeping will pose a major compliance burden for taxpayers in order to ensure that they have all the necessary documentation in place to satisfy an enquiry by the ATO. As another layer of compliance the tax legislation provides specific record keeping requirements for foreign entities investing directly in Australia. These special record keeping rules apply in respect of the thin capitalisation provisions and address the methodology and assumptions used in making revaluations of assets and liabilities in determining whether the relevant debt to equity ratios are satisfied.

Complying with the transfer pricing rules also poses record keeping issues at a number of levels. Firstly, taxpayers have to ensure that appropriate documentation is in place when setting or reviewing their transfer pricing process. Secondly, data used in support of the functions performed, assets and skills utilised, risks assumed and market and economic context in which the parties are operating must be adequately documented. Finally, the particular methodology adopted in determining an appropriate arm's length consideration for a particular transaction must have the requisite supporting documentation.

As a final comment, it is important to keep in mind that the ATO may apply the transfer pricing rules notwithstanding the fact that an entity may pass the thin capitalisation rules (i.e. not have excess debt). In other words, the ATO may determine an appropriate arm's length cost for a taxpayer's debt funding.

Based on the ATO's recognition that cross-border transactions pose a serious threat to the revenue, taxpayers should be made aware that their tax affairs will (sooner rather than later) come under closer scrutiny and they must ensure that they have their house in order and are well prepared to respond to any enquiry when the taxman comes calling.

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Belgian considerations on cross-border tax loss utilisation

The ability to offset tax losses against profits for assessing the tax liability of a domestic group of companies is a basic feature of any company tax system. However, the rules on tax loss compensation differ substantially at domestic and international level, i.e. while none of the EU Member States have basic problems with national tax loss compensation, the use of foreign tax losses is restricted or impossible.

An important feature in this discussion is the clear distinction in an EU-wide taxation system between the treatment of foreign tax losses occurring within a permanent establishment (PE) context (whereby these results of the PE form an integral part of the total results of the single legal entity) or occurring within a subsidiary context (whereby the results do not form part of the results of a domestic parent company).

In the early 1990s, the European Commission brought forward a proposal for a directive on the use of tax losses of both PEs and subsidiaries. The underlying principles were that there is no justification for the discrimination between both situations and that relief should be available in the home state of the parent company/head office. This proposal has been gathering dust ever since then. In recent years, the European Court has been playing an increasingly significant role since its responsibility is, amongst others, ensuring that the Member State Law is observed in the interpretation and application of the Treaties and the freedoms embedded therein.

Hereafter, we briefly comment on some aspects of the Belgian tax system and the administrative positions taken in this sensitive matter.

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belgium

Cartemois Bridge
in Bouillon

1. General tax loss treatment

As a preliminary remark, we note that Belgium only allows a carry forward of tax losses. No carry back mechanism is in place. Tax losses can be carried forward indefinitely in time and the utilisation thereof in a given tax period is not subject to a cap or a floor. Another general principle states that only the company that initially incurred the tax loss can use it in the future. Only in the case of a merger/scission do specific deviating rules apply.

Belgium does not provide for a tax consolidation at the level of corporate income tax. For VAT purposes, consolidation is optional provided certain conditions are met. Proposals to introduce tax consolidation at the level of the corporate income tax have been launched on several occasions, but budgetary constraints have prevented actual implementation.

As Belgium does not have a system of formal tax consolidation (national or international), Belgian entrepreneurs have tried to install a system of informal tax consolidation by creatively handling transfer pricing principles, allocation of management and overhead costs.

2. Cross-border legislation

As indicated, Belgium does not allow the takeover of tax losses between two legal entities either in a national or a cross-border context. In this respect, taking the tax losses of a subsidiary is thereby prevented. However, Belgium does recognize foreign tax losses incurred if the foreign activity is carried out through a PE instead of a subsidiary. By doing so, foreign tax losses can initially be used to offset Belgian taxable income. Recapture occurs at the moment those same tax losses are used abroad. Since the Velazquez doctrine was abolished, foreign profits (on the basis of the double tax treaty exemption) no longer compensate Belgian tax losses.

As indicated above, the situation is totally different if the activity abroad is carried out by a foreign subsidiary. In that case there is no compensation possible. Equally in the case of liquidation of the foreign subsidiary, the tax losses that a subsidiary has incurred in the past cannot be used at the level of the parent company (only eventual tax loss of paid in capital at the occasion of liquidation will provide for a tax cushion).

3. De facto tax consolidation and anti-abuse measures

In the absence of tax consolidation, Belgian entrepreneurs have tried to install a system of informal tax consolidation by creatively handling transfer pricing principles, allocation of management and overhead costs. In a mere national context, the Belgian tax authorities usually have little incentive to tackle the issue as it does not normally lead to an erosion of the overall Belgian taxable basis. Of course, in a cross-border context, things change. Taking into consideration the high nominal tax rate of 33.99%, taxable profit is usually exported rather than imported. Therefore, the legislator has provided for a number of specific anti-abuse provisions in the income tax code:

- Article 26, 2nd limb Income Tax Code (ITC) provides for taxation in Belgium of abnormal or benevolent advantages granted to non-residents. In a national context, the provision does not apply to the extent the beneficiary of the advantage is taxed (directly or indirectly) on the said advantage. In an international context, taxation always occurs. In January last year, the European Court confirmed that this is no violation of the freedom of establishment or the freedom of capital as any Member State would lose its authority to tax if profits could be shifted cross-border unchecked and unchallenged.
- Article 54 ITC is similar to the foregoing but it reverses the burden of proof for certain types of costs. To the extent that the tax authorities can claim the application thereof, the article provides for a deemed non-deductibility of the expense. It is up to the taxpayer to prove that, for instance, commissions paid relate to genuine business transactions and are not excessive. In September last year, national Court Rulings pointed out that commission fees paid to Hong Kong and Panama failed the substance test. In 2008, similar Court Rulings already targeted Panama, Liechtenstein and the Bahamas.
- Article 198, 11^o ITC is a thin cap provision that may prevent deduction of interest payments to certain foreign jurisdictions (7:1 ratio). Here also the shift of a tax matter out of Belgium is to be avoided.

Belgian libraries are piled with books and essays on the notion of "abnormal or benevolent advantages" especially on the ongoing discussions between the tax authorities and jurisprudence. Whereas the first is very stringent in its interpretation on a "stand alone" basis to evaluate the benevolence, the latter shows more economic reason. In a vast number of cases, jurisprudence has allowed that group interests are an element of evaluation. The mere fact that a Belgian company may state an act that it would not state towards a third party does not automatically make it benevolent or abnormal (i.e. foregoing of debt). Also, more recently, the Belgian ruling committee has shown economic reason by confirming that serving group interests is an economic and not a tax driven guideline.

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China

How to defend cross-border loss utilisation in China

On 6 July 2009, China's State Administration of Taxation (SAT) issued Circular 363 with the objective of strengthening the monitoring and investigation of cross-border related party transactions.

In Circular 363, the SAT takes the view that prima facie, loss-making in limited-function enterprises is because of transfer pricing (TP) manipulation and therefore the onus to prove otherwise lies with the taxpayer:

china

The 17 Arch Bridge at the Summer Palace in Beijing

The sectors affected are cross-sector but with a focus on areas such as contract manufacturing, toll manufacturing, distribution, toll research and development.



The key points to note are:

- Entities that are established in China by multinational companies and have limited functions and risks such as those with a sole function of production, distribution or contract research and development etc., should not bear the market risk or risks associated with decision-making activities. Consequently, such entities should maintain a reasonable level of profit pursuant to the TP principle of “functions and risks” commensurate with profitability.
- Loss-making single-function entities will need to prepare and submit contemporaneous documentation, regardless of whether their related party transactions exceed the prescribed thresholds. They are required to submit the contemporaneous documentation to the in-charge tax authorities by 20 June following the year in which their losses occur.
- The local tax authorities shall focus on multinationals attempting to:
 - Shift overseas operating losses (including potential losses) to Chinese entities.
 - Move domestic profits made by Chinese entities to tax havens.
- The potential impact on businesses will be:
 - An increase in effective tax burden.
 - An increase in TP exposures.
 - An increase in compliance costs.

In view of Circular 363, multinationals should be aware of and appreciate the tightness of the net that is being drawn around loss-makers. Self-assessment should therefore be conducted by entities or enterprises as to whether they are subject to Circular 363.

Here are some possible ways to deal with loss-making enterprises:

- Analyze group information to show that other entities (located outside China) within the group are also in a loss situation.
- Show that the losses are due to domestic management or operational inefficiencies, such as high manufacturing defect rates, transitional learning or experience issues.
- Show that the losses are due to non-related party transactions.
- Demonstrate that all receipts or payments for the loss-making entity are based on market prices.
- Demonstrate that comparable companies are in a loss position using special industry benchmarking.
- Prove that the loss-making entity is not a limited risk or function entity and it has significant decision-making authority.

It is essential that the above strategies are carefully tailored and reinforced with facts and analysis to secure a supportable position.

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Cross-border loss utilisation in Italy

According to the tax legislation in Italy there are provisions that allow cross-border loss utilisation in certain situations.

Worldwide fiscal unity

The worldwide fiscal unity is a method for determining the tax basis of group companies with foreign controlled companies.

The control requirement is met when the participating company holds, directly or indirectly, more than 50% of the share capital of the controlled company.

The conditions to be met for the election of the worldwide fiscal unity are the following:

- All group companies shall opt for the worldwide fiscal unity, “all in all out” principle.
- All group companies shall have the same fiscal year-end.
- Financial Statement of all group companies shall be certified by an audit company.
- Presence of companies that are listed in any stock exchange.

The taxable basis of the consolidated group is determined by adding the single taxable results (positive and negative) of all companies in proportion to the profit participation held by the controlling company.

The option is not revocable for five years, and possible revisions are for minimum three years.

Tax payable is determined by deducting from taxes due (calculated by applying the corporate income tax rate to the group’s taxable income) foreign tax credits related to the taxes paid abroad by the foreign subsidiaries.

The losses incurred by all group companies before the option has been made are not included in the fiscal unity.

Due to the restrictions indicated by law, the worldwide fiscal unity is not very popular.

Domestic fiscal unity

The domestic fiscal unity involves only Italian companies.

The control requirement is the same as for the worldwide fiscal unity; this is met when the participating company holds, directly or indirectly, more than 50% of the share capital of the controlled company.

The condition of the same fiscal year-end for all group companies is in this case applicable as well.

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italy

Vittorio Emanuele
Bridge over the
Tiber river
in Rome

The domestic fiscal unity can also be established in case the ultimate shareholder is not resident in Italy. In this case the fiscal unity's perimeter will be at the level of the Italian company.

The option of the domestic fiscal unity is not revocable for three years, and it can be renewed for three years.

In this case the principle "all in all out" does not apply, and it is possible to choose which companies will be a part of the unity.

The group taxable basis is equal to the sum of all the companies' taxable results (positive and negative), regardless of the percentage of participation of the controlling company; in other words, every controlled company will transfer the entire result and not in proportion to the percentage of the ownership.

As per worldwide fiscal unity, the tax losses incurred in previous years prior to the option will not be transferred to the group.

Flow-through taxation

The companies' ordinary taxation method is the single taxation of the result.

The flow-through taxation method can be applied per option; in this case the taxation will be on a transparent basis regardless of the real transfer of the profits (dividend).

The option can be made only by companies owned by other companies with a participation that ranges from 10% to 50%.

The shareholders shall be resident or non-resident, in the second case the election is only valid if, in case of dividend payment, no withholding tax is applicable (i.e. Parent-Subsidiary Directive).

The above mentioned conditions shall be met by all shareholders.

The flow-through taxation method is the alternative method for the fiscal unity and it cannot be chosen if the shareholders can benefit from any Corporate Income Tax (CIT) reduction.

This option must be exercised by all companies involved and may not be revoked for three years.

The distribution of dividends will not be taxed within the limit of profits before being transferred transparently.

Taxation of foreign company with an Italian branch

The general rule for the taxation of non-resident companies is that they are taxed only on incomes gained from the Italian territory.

The business incomes gained by a non-resident through a permanent establishment (PE) located in Italy are taxed in Italy, and the losses gained by the PE can be carried forward to the next five years. According to the domestic tax discipline of the foreign mother company, whenever the Italian PE will gain profits, there should be a tax credit that is deductible in the mother company's country of residence. The same check should be made for losses incurred by the Italian PE.

Taxation of Italian company with a foreign PE

Italian companies are liable to taxation in Italy on the worldwide principle basis, including the incomes gained or losses incurred in other countries on behalf of the PE where it is located.

In the case of foreign PE incomes, a foreign tax credit is allowed for deduction; on the other hand, in the case of losses, they will be compensated with the Italian tax basis.

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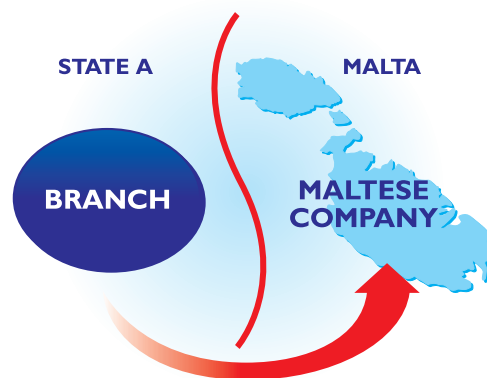
Malta

Cross-border loss utilisation in Malta

The transfer of trading losses from a Maltese registered company to either its subsidiary or branch located in another jurisdiction is dependent on:

- Whether it is a branch or a subsidiary.
- Whether there is a double taxation convention signed between Malta and the other State.

Scenario I: A Maltese company having a branch in State A



TRANSFER OF LOSSES

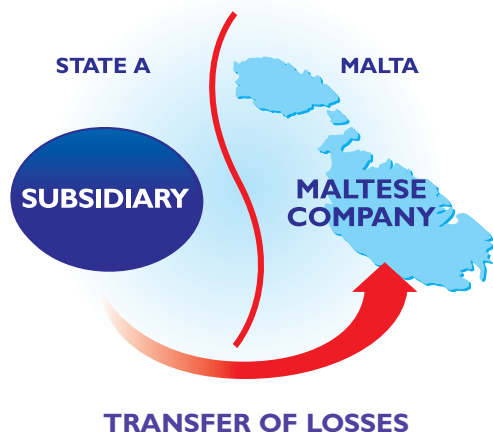
Given that there is a double taxation treaty in force between Malta and State A, the branch in State A would constitute a permanent establishment of the Maltese Company in State A. Most of the double taxation treaties which Malta has are based on the OECD Model Convention, and consequently the branch profits may be taxed in Malta in accordance with the treaty. Likewise, losses can be transferred to the Maltese company and offset against the Maltese company profits.

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malta

In a scenario where there is no double taxation treaty between Malta and State A, the latter will tax the branch profits in accordance with its domestic tax rules.

Scenario 2: A Maltese company having a subsidiary in State A



The Maltese Income Tax Act provides that in order for two companies to surrender trading losses to each other, they must form part of the same group of companies. In order to meet the definition of a group of companies in accordance with the Act, one of the conditions is that the *two companies must be resident in Malta and neither one of them must be resident for tax purposes in any other country*. This means that losses of the subsidiary in State A cannot be offset against the Maltese Company's chargeable income since only members of the same group of companies can transfer losses between them.

However, given that State A is an EU Member State, one could argue that as only *Maltese resident companies* can surrender losses to each other, this is in breach of European Law with respect to Freedom of Establishment (**Case C-414/06 - I Lidl Belgium**).

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The Netherlands

A brief overview of cross-border loss utilisation

Dutch tax legislation allows loss utilisation for domestic companies and foreign taxpayers having a Dutch permanent establishment (PE).

Dutch losses can be offset against Dutch profits: as a main rule cross-border loss utilisation is not possible in the Netherlands.

Cross-border loss utilisation is only allowed in certain specific situations. An overview is given below.

Loss utilisation in the Netherlands

The Dutch tax regime allows the carry forward and carry back of tax losses. There are limitations: tax losses can be carried forward nine years and carried back one year.

In 2009 the Dutch government introduced some temporary measures to stimulate the Dutch economy. Since 2009 losses can be carried back three years. However, if the taxpayer applies this rule losses can be carried forward for no more than six years. This temporary measure is applicable at least until the end of 2011.

Dutch company and PE

In case a Dutch company has a PE, the Dutch company can deduct the losses incurred by the PE from its domestic tax base. However, as soon as the PE becomes profitable these foreign profits will not be tax exempt in the Netherlands until the moment that the PE losses have been compensated.

Foreign company and Dutch PE

A foreign company with a Dutch PE is liable to tax in the Netherlands. Therefore a Dutch PE can offset Dutch losses against Dutch profits (the same rules apply to the Dutch PE as to a Dutch company).

Fiscal unity (tax consolidation)

In the case of a Dutch fiscal unity Dutch resident companies consolidate their results in one tax return. A fiscal unity is only possible for resident companies. A foreign entity cannot be part of a Dutch fiscal unity. This means that the losses of a Dutch subsidiary can be compensated with the profits of another Dutch affiliated company which is part of the fiscal unity. Because a foreign affiliate cannot be part of a Dutch fiscal unity foreign losses cannot be compensated. However, in the case where a foreign subsidiary has a PE in the Netherlands, loss compensation is possible with the PE because the PE can be a part of the Dutch fiscal unity.

Liquidation of a subsidiary

Under the Dutch participation exemption both dividends and capital gains/losses are tax exempt for the Dutch parent owning a shareholding in a qualifying subsidiary. It means that the losses of a foreign company are not deductible in the Netherlands at the level of the Dutch parent. However, the Dutch government has made an exception for liquidation losses.

The liquidation loss regime prevents that liquidation losses will be lost forever and cannot be offset against any future profits. Therefore, a Dutch parent company can settle a loss in relation to the liquidation of its subsidiary against its own taxable profits.

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netherlands

Zeelandbrug in
Zeeland

The liquidation loss is calculated as the (positive) difference between the amount sacrificed by the parent company for the participation and the total benefits derived from the liquidation of the participation. The sacrificed amount is equal to the amount paid for the shares. However, an exception is made for investment companies situated in low tax countries and non-taxable investment companies. For those participations the sacrificed amount is deemed to be equal to nil.

Liquidation losses may only be considered when the liquidation of the participation is fully completed. Moreover, in order to qualify for the regime the activities of the liquidated company should not be continued somehow by another group company.

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South Africa

Utilisation of tax losses in South Africa

South Africa does not allow the utilisation of tax losses across borders. In a situation of a holding company in South Africa and subsidiaries in, for example, Botswana, Swaziland, Lesotho and Mozambique, none of the losses from any of the subsidiaries can be utilised by the holding company against its taxable income. A provision to Section 20 (1) of the Income Tax Act states that any assessed loss from a trade carried on outside the Republic of South Africa cannot be offset against income derived from any trade being carried on within the Republic.

The Income Tax Act in South Africa also does not allow groups of companies to offset tax losses within the group. There are proposals to review the tax legislation to make the tax environment in South Africa friendlier in an international tax sense, to allow foreign investment into the country. The proposal is to permit tax losses within groups to be utilised as well as looking at utilisation of tax losses across borders.

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Romania

New regulations for the relief of tax losses of foreign PEs

As a part of the alignment process of national fiscal policy with European law, the Romanian Government issued Emergency Ordinance no. 58/2010. The ordinance came into force on 1 July 2010 and introduced a number of changes including new provisions for cross-border tax losses utilisation.

Under the previous tax provisions, in the cross-border situation, losses derived from a domestic permanent establishment (PE) are taken into account at the level of the Romanian head office. Any losses realised by a foreign PE of a Romanian head office will be offset against the future income derived from that PE.

As from 2010, losses incurred by a foreign PE located in a European Union/European Free Trade Association (EFTA) country of a Romanian head office, or located in a country in which Romania has concluded a double taxation convention, will be taken into account at the level of the Romanian head office.

The annual fiscal loss shall be recovered from the taxable profits obtained during the following seven sequent years. According to the legal provisions that came into force as from 2010 the recovery of losses can only be made in the year in which such losses are recorded.

Unfortunately, no norms or procedures have been published yet in respect of the new regulation, therefore no other details are available at the moment.

We hope that the Romanian government will issue in the near future the methodological norms in respect of the specific conditions regarding the cross-border loss utilisation.

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Sweden

Transfer of losses within a group – in the wake of Marks & Spencer

According to Swedish national tax legislation, tax losses are generally carried forward without any restriction. Furthermore, a part of a taxable profit could be appropriated to a tax allocation reserve that may be dissolved in a later year when a tax loss arises.

Tax optimisation within a Swedish group with losses may be achieved by a group contribution from a limited liability company with a taxable profit to a group company with a tax loss. In order to do so the parent companies' ownership should have a minimum of 90% (below "wholly-owned"). The group contribution is a deductible cost for the transferor, and is included in the taxable income for the transferee. The transfer creates a receivable/debt between the companies involved that has to enter into the accounts. Therefore, it is not only a filing issue. The ownership by the parent company must generally be satisfied for the entire financial year unless a new subsidiary without any business is formed or acquired. The purpose of the rules is to create neutrality between businesses conducted in one company and businesses divided and conducted in several companies.

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sweden

The conditions regarding wholly-owned makes it impossible to transfer group contributions to, e.g. joint ventures, where ownership is for example equal. According to the Swedish tax law, another restriction is that transferor and transferee should be a Swedish company or alternatively a European Economic Area (EEA) company with a permanent establishment in Sweden. The Swedish Supreme Administrative Court has made a decision regarding the regulation. The Court decided that the regulation was contrary to EU rules as provided in the European Court of Justice (ECJ) cases (Marks & Spencer and Oy AA).

According to the decision in the ECJ cases, Sweden has implemented new legislation regarding cross-border loss utilisation. Therefore, the Swedish government allows under certain circumstances cross-border loss utilisation for group relief.

The tax legislation allows for a Swedish parent company to transfer a group contribution to a wholly-owned foreign subsidiary established in a country within the EEA area. Therefore, a transfer to a Swedish parent company or to a company established outside of the EEA area is not allowed. Effectively, it is possible to receive a tax deduction for a final loss in the subsidiary. The deductible losses are restricted. Furthermore, the losses have to be final and they cannot be offset against profits in the other country. In order to receive a tax deduction for the amount that the subsidiary has transferred to the parent company, the loss of the subsidiary must be determined at the time of liquidation.

The case that a transfer of losses exceeds the taxable income in the parent company is not allowed. If there is another ongoing business within a group in the same country where the liquidated subsidiary was established, there are no further possibilities for cross-border group relief to use loss utilisation.

Due to the Swedish capital gains tax exemption the loss arising from a disposal of business related shares is not available, e.g. at a liquidation. The cross-border group relief for loss utilisation enables access to losses in a subsidiary through liquidation.

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United Kingdom

Cross-border loss utilisation in the UK

There are provisions in the UK tax legislation that allow for cross-border loss relief in certain situations.

UK entity with a foreign branch

If a UK partnership or company operating a branch in a foreign jurisdiction incurs losses in the foreign activity, the losses incurred there may be used against the UK profits. The two main conditions are that they:

- Are not used against future profits of that foreign activity.
- Would be eligible for UK tax relief if they had been incurred in the UK.

In addition, they may only be used against UK profits to the extent that there are no other foreign profits available to be offset for that period.

Foreign entity with a UK branch

Similar to the above loss relief, a UK-resident company can claim losses from the UK branch of a foreign company in its group (75% ownership) if all the following conditions are met:

- The loss is attributable to activities under the charge to UK corporation tax.
- The loss is not from activities that are exempt from double taxation.
- The loss has not already been claimed against that company's foreign profits.

Foreign entity with foreign activities

European Economic Area (EEA) losses incurred by a non-UK resident company may be surrendered to a UK group company under certain circumstances. An "EEA loss" is defined as a tax loss calculated under the laws of the EEA country that the non-UK resident company operates in, which are from operations that are not exempt from tax.

This piece of UK legislation is the result of a recent Marks & Spencer plc case; the UK company claimed Belgian losses of a Belgian subsidiary and German losses of a German subsidiary against its UK profits. The Belgian and German subsidiaries were to be liquidated. HM Revenue & Customs (HMRC) denied the use of the losses in this way, citing that the second condition below was not met.

After the case was heard in the European Court of Justice (ECJ) and the High Court, the UK introduced the following legislation.

The conditions are that:

- The loss cannot have been utilised against the profits of the surrendering company's non-UK activities.
- The loss must not be able to be used against future profits arising from non-UK activities; in essence, the loss can only be surrendered if there is no possibility that the EEA loss can ever be used.
- The losses were incurred after 1 April 2006.

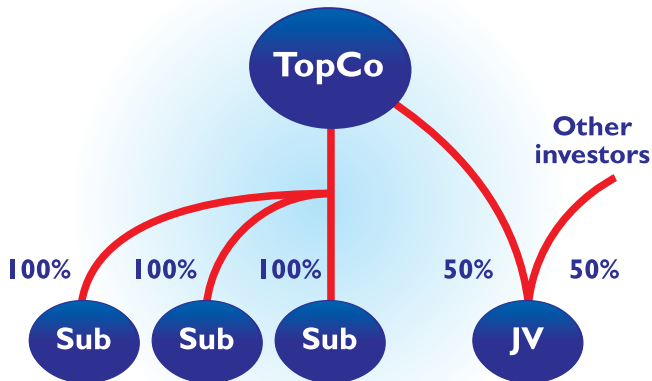
The European Commission perceived this legislation to be too restrictive and referred the UK to the ECJ in October 2009. This decision is pending.

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united kingdom

Consortium relief

The UK legislation also provides for losses to be surrendered from a loss-making UK activity to a profit-making UK company that may not be in the same group but is in the same "consortium".



If the joint venture (JV) is a UK company or has a UK branch, and has UK losses, it can surrender relevant losses for use against TopCo's UK profits or any of Subs' UK profits.

UK law states that TopCo must be a UK company. However, in a recent case of *Philips Electronics UK Ltd v HMRC*, where TopCo was a Dutch company, a UK court ruled that UK law was incompatible with EU law in this respect. In the same case, it was ruled that the loss could not be restricted even if it could have been used elsewhere e.g. against Dutch profits arising in the group.

UK companies with loss-making consortium members are encouraged to submit the relevant loss claims, in line with the result of this case.

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Rules governing the use of "net operating loss"

US tax law provides various rules governing the use of a "net operating loss" by a US corporation or by a branch of a foreign corporation engaged in business in the United States. A net operating loss is the excess of the corporation's deductions over its gross income.

Use of net operating loss by the same corporation

If the corporation does not file a consolidated return with its affiliates, it may carry a net operating loss back to the two preceding years. If there is not sufficient income to absorb the net operating loss in those years, it may be carried forward and applied in the succeeding 20 years. For example, a net operating loss incurred in 2010 may be carried back to 2008 and 2009, and may be carried forward as far as 2030 if it is not absorbed in an earlier year.

In most instances, a net operating loss must be applied to the earliest available year in which there is income to absorb it. However, a corporation may elect not to carry the loss back to an earlier year and to apply it only to subsequent years instead.

Use of net operating loss by an affiliated corporation

US tax law provides a form of group relief. Certain affiliated US corporations are allowed to compute their taxable income and tax liability on a consolidated basis and file a single, consolidated tax return. The consolidated return rules effectively allow the net operating loss of one member of the group to offset income of another member of the group. If the entire consolidated group has a net operating loss, the consolidated loss generally may be carried backward two years and forward 20 years. However, special rules may apply to limit the use of a consolidated net operating loss if corporations enter or leave the consolidated group.

Transfer of net operating losses

US tax law allows the net operating loss of one corporation to carry over and become the net operating loss of another. However, to prevent tax motivated "acquisition of losses" the use of the losses may be reduced or eliminated if there is a significant change in ownership.

For example, if one corporation merged into a second corporation, the second corporation generally inherits the net operating loss of the first corporation. However, the extent to which the loss may be used by the second corporation depends on the extent of the change in ownership. If the two corporations ultimately were owned by the same persons, use of the "acquired loss" by the second corporation would not be limited. On the other hand, if there is a substantial change in ultimate ownership as a result of the merger, use of the loss going forward would be limited. The extent of the limitation depends on the extent of the ownership change.

Similar rules apply in situations in which stock of a corporation is purchased but the corporation continues to exist. As the net operating loss is an attribute of the corporation, the net operating loss continues to exist despite the change in stock ownership. However, use of the net operating loss going forward can be limited depending on the extent of the change in ultimate ownership of the corporation and the value of the loss corporation at the time of the ownership change.

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Tax Link serves two purposes. It provides a forum for updating our clients and contacts on developments in tax legislation around the globe and for highlighting the range of tax services available from Nexia member firms. In addition, Tax Link serves as a notice board to inform member firms on the activities of the various tax committees and focus groups within the Nexia network.

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