



Corporate Loss Utilisation through Aggressive Tax Planning



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Foreword

Aggressive Tax Planning is a source of increasing concern for many countries. Numbers at stake are vast, often in the order of billions of dollars. Countries have developed various strategies to deal with aggressive tax planning and international co-operation features prominently among them. Working co-operatively countries can deter, detect and respond to aggressive tax planning in an effective way while at the same time ensuring certainty and predictability for compliant taxpayers.

Due to the recent financial and economic crisis, the amount of global corporate losses is enormous. Over and above the immediate tax revenue impact of these losses as a result of the normal operation of countries' loss relief rules, these losses also raise tax compliance risks, in particular if companies turn to aggressive tax planning as a means of increasing and/or accelerating tax relief on their losses.

This report, which deals with aggressive tax planning involving corporate losses, has been prepared jointly by the Forum on Tax Administration (FTA) and the Aggressive Tax Planning (ATP) Steering Group of Working Party No. 10 on Exchange of Information and Tax Compliance of the Committee on Fiscal Affairs (CFA).

The term “losses” has to be understood broadly for purposes of this report: although the report deals primarily with the tax treatment of taxpayers which have suffered overall losses, it also examines issues relevant to deductions which may reduce a taxpayer's profits without necessarily resulting in an overall loss. The report deals with both real and artificial losses, as well as with the issue of multiple deductions of the same loss, typically through hybrid mismatch arrangements.

The analytical framework of report builds on the earlier OECD report *Addressing Tax Risks Involving Bank Losses* (2010), which explores the different country approaches to giving tax relief to loss-making banks and to addressing tax risks involving banks' losses. It reflects the experiences of 17 countries who participated in the study team: Australia, Austria, Canada, Denmark, France, Germany, Ireland, Italy, Mexico, the Netherlands, New Zealand, Norway, Spain, Sweden, Switzerland, the United Kingdom and the United States. The study team was led by Germany and the OECD Secretariat.

In addition to describing the size of corporate tax losses and the policy issues related to their tax treatment, the report identifies three key risk areas in relation to the use of losses for tax purposes: corporate reorganisations, financial instruments and non-arm's length transfer pricing. The report summarises aggressive tax planning schemes encountered by revenue bodies in participating countries, together with their detection and response strategies and offers a number of conclusions and recommendations. I would like to thank all of those who have worked on the completion of this report. I hope that it will be widely used by tax policy makers, tax administrators, and other stakeholders.

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Abbreviations

| | |
|-----------------|------------------------------------|
| ATP | Aggressive Tax Planning |
| CFC | Controlled Foreign Companies |
| DCL regulations | Dual Consolidated Loss regulations |
| GDP | Gross Domestic Product |
| LP | Limited Partnership |
| MCNs | Mandatory Convertible Notes |
| PE | Permanent Establishment |

Executive Summary

Due to the recent financial and economic crisis, the amount of global corporate losses is enormous. Over and above the immediate tax revenue impact of these losses as a result of the normal operation of countries' loss relief rules, these losses also raise tax compliance risks, in particular if companies turn to aggressive tax planning as a means of increasing and/or accelerating tax relief on their losses. This report deals with corporate tax losses. The term "losses" has to be understood broadly for purposes of this report: although the report deals primarily with the tax treatment of taxpayers which have suffered overall losses, it also touches on issues which are relevant to deductions which may reduce a taxpayer's profits without necessarily resulting in an overall loss. The report deals with both real and artificial losses, as well as with the issue of multiple deductions of the same (real or artificial) loss, typically through hybrid mismatch arrangements.

The report finds that the gathering of country specific data in the area of loss carry-forwards is complex, as countries sometimes have different approaches in relation to the collection of data. Some countries collect data on a yearly basis, others on a multi-year basis, while in other countries data about loss carry-forwards are not collected as a matter of course. Furthermore, in many cases it is not possible to break data down by company size or industry. Although the collected data are often difficult to compare, some general conclusions are drawn from the data provided by participating countries. These conclusions refer to the fact that the size of loss carry-forwards is constantly increasing and this increase accelerates in downturn years. Further, loss carry-forwards as a percentage of GDP show large differences among countries, with some as high as 25%. These differences may reflect restrictions on the use of losses introduced by some countries; they may also to some extent simply reflect measurement differences in the data provided by various countries.

The report also discusses policy considerations related to the use of losses for tax purposes. These policy considerations are reflected in the applicable tax systems which, on the basis of the choices made, allow, deny or restrict the use of losses for tax purposes. Where loss offset is subject to legal restrictions, some enterprises may seek ways to circumvent those restrictions. This can have negative overall effects if its outcome is in conflict with the policy choices underlying the tax system. When analysing issues related to the use of losses for tax purposes it is therefore critical to understand the applicable rules and the policy choices underlying them.

The report therefore describes country rules in relation to losses. The extent to which loss relief is available – whether against the taxpayer's own profits of the same, previous, or later periods, or against the profits of other related companies – differs markedly from country to country. The report covers specifically the following rules: sideways loss relief, group taxation regimes, carry-over of losses, use of pre-existing losses in the case of mergers, losses of a foreign PE, losses of a foreign subsidiary, and restrictions on dual use of losses. It finds that the complexity of country rules regarding losses and the potential opportunities for taxpayers to exploit differences among country rules through aggressive tax planning, are themselves a source of tax risk. Country rules which do not contain any restrictions on the use of carried-forward or built-in losses in the case of mergers, acquisitions or group taxation regimes are more exposed to aggressive tax planning. Several countries introduced temporary measures on the use of

losses for tax purposes to support companies in the course of the global financial crisis. Finally, the report notes that an increasing number of countries deal expressly with the dual use of losses.

The report describes a number of aggressive tax planning schemes on losses. These schemes aim at achieving a variety of results, such as loss-shifting schemes, schemes shifting profits to a loss-making party, schemes circumventing time restrictions on the carry-over of losses, schemes circumventing change of ownership/activity restrictions on the carry-over of losses, schemes circumventing rules on the recognition or treatment of losses, schemes creating artificial losses and schemes involving the dual/multiple use of the same loss. Based on these schemes, the report identifies key risk areas in relation to losses. These key risk areas include the use of financial instruments, corporate reorganisations, and non-arm's length transfer pricing. Needless to say, financial instruments, corporate reorganisations, and intra-group transactions are generally made for sound business and economic reasons but in some cases they can be used inappropriately to allow an unintended use of losses for tax purposes.

Financial instruments have for example been used to shift profits or losses among different taxpayers, thus allowing taxpayers to make use of their losses currently or to circumvent time-limitations and/or change of ownership or activity restrictions. Participating countries have also identified a number of schemes where financial instruments are used to create artificial losses, *i.e.* losses which are only generated for tax purposes with no economic loss incurred anywhere by anyone. These arrangements typically seek to create expenses or losses to offset other income, generally avoiding the taxation of any corresponding gain or profit. Finally, financial instruments have been used to obtain multiple deductions of the same loss, an area of great concern for revenue bodies.

Corporate reorganisations which raise concerns from the perspective of revenue bodies are for example the acquisition of a loss-making company for the sole or main purpose of merging it or including it in the tax group with profit-making companies, therefore reducing the profits of other group companies by the losses of the acquired company. Other techniques which raise concerns are related to the acquisition of loss-making companies towards year-end, before losses materialise for tax purposes. Some participating countries have noticed an increase in such acquisitions, which may be due to the fact that restrictions on the carry-over of losses or on the use of losses in the different forms of group taxation regime in some cases do not apply in relation to parts of a tax period.

Non-arm's length transfer pricing practices which raise concerns are for example tax-motivated changes of the entrepreneurial structure and purported changes in the transfer pricing policy of the group. Revenue bodies are concerned that in some cases these loss-making financial assets may be allocated to relatively high-tax jurisdictions, through non arm's length transactions or dealings. The application of the arm's length principle is critical to ensure that transfer (mis-)pricing is not used to transfer losses to profitable entities within the group, or to countries whose loss relief rules are relatively more generous. Transfer pricing risks can potentially arise for instance from the misallocation of income/expenses within a multinational group, or from the over-pricing or under-pricing of transactions. Transfer pricing concerns have also been identified in some participating countries in relation to financial transactions, for example non arm's length prices for guarantee fees and related party interest rates, and after-tax hedges.

The detection of aggressive tax planning schemes on losses usually takes place through audits and disclosure initiatives. Disclosure initiatives which have proven to be very useful in helping tax administrations detect schemes on losses in a timely manner include: special reporting obligation on losses, mandatory disclosure rules, rulings and co-operative compliance programmes. Data analysis, including the use of the ATP Directory, has often contributed to the detection of ATP schemes on losses. The report notes that countries have successfully applied several detection strategies simultaneously and

also mentions that some countries have started using predictive models on the future use of losses, both as a revenue-forecasting tool and as an indicator of aggressive tax planning on losses.

As regards the responses to aggressive tax planning schemes on losses, the report concludes that it is important to have a comprehensive approach focusing on supply, demand and products. General and specific anti-avoidance rules are often used to deny benefits to taxpayers in relation to aggressive tax planning schemes on losses. On the other hand, early engagement between taxpayers and tax authorities through co-operative compliance programmes has resulted in some schemes not being implemented by the taxpayer. At the same time, co-operative compliance programmes have also resulted in early resolution of potential tax disputes involving losses and additional intelligence on aggressive tax planning for tax authorities. Mass media (“one-to-many”) approaches used by some countries play an important role for influencing taxpayers’ and promoters’ behaviour regarding tax compliance.

Building on the work of the Aggressive Tax Planning Steering Group and of the Forum on Tax Administration, the report recommends countries to:

- consider exploring, through Working Party No. 2 of the Committee on Fiscal Affairs, the reasons for the results outlined in Chapter 2 of this report and any improvements required to country techniques for the collection of data on losses;
- consider introducing or revising restrictions on use of losses, including built-in losses, in cases of mergers, acquisitions, or group taxation regimes, to the extent they are concerned with aggressive tax planning on the use of losses in these cases;
- consider introducing restrictions on the multiple use of the same loss to the extent they are concerned with these results;
- evaluate the economic and revenue impact of temporary measures on the use of losses for tax purposes with a view to deciding whether or not those measures should be abolished, extended or made permanent;
- analyse the policy and compliance issues raised by schemes such as after-tax hedges and evaluate the options available to address them;
- continue to share relevant intelligence on aggressive tax planning schemes on losses, their detection and response strategies, and measure the effectiveness of the strategies used, for example in terms of additional tax revenue assessed/collected, or in terms of enhanced compliance;
- consider the introduction of co-operative compliance programmes, where appropriate to a country’s circumstances, based on the benefits to both taxpayers and tax administrations;
- consider the introduction or the revision of disclosure initiatives targeted at aggressive tax planning schemes on losses.

Introduction

Due to the recent financial and economic crisis, the amount of global corporate losses is enormous. Over and above the immediate tax revenue impact of these losses as a result of the normal operation of countries' loss relief rules, these losses also raise tax compliance risks, in particular if companies turn to aggressive tax planning as a means of increasing and/or accelerating tax relief on their losses.

This report deals with corporate tax losses. The term "losses" has to be understood broadly for purposes of this report: although the report deals primarily with the tax treatment of taxpayers which have suffered overall losses, it also examines issues relevant to deductions which may reduce a taxpayer's profits without necessarily resulting in an overall loss.

The report deals with both real and artificial losses, the latter constituting an even greater source of concern for revenue bodies. For the purposes of this report, schemes on real losses are those where the taxpayer seeks to use losses which have been economically incurred somewhere, by the same taxpayer or by a different one, in ways not intended or contrary to the principles underlying the relevant rules. On the other hand, artificial losses are those arising from schemes that seek to generate losses for tax purposes with no economic loss arising anywhere, whether at the level of the taxpayer claiming loss relief or somewhere else.

The report also addresses the issue of multiple deductions of the same (real or artificial) loss, typically through hybrid mismatch arrangements.

In addition to describing the size of corporate tax losses and the policy issues related to the treatment of losses, the report gives an overview of the relevant tax rules regarding losses. It also identifies key risk areas in relation to losses and describes aggressive tax planning schemes encountered by revenue bodies in participating countries, together with their detection and response strategies. The report concludes with a number of conclusions and recommendations for revenue bodies and tax policy officials.

Chapter 1

Size of Corporate Tax Losses

This chapter presents data on the size of corporate loss carry-forwards in 11 of the 17 countries that participated in this study. It discusses the potential impact on future government revenues.

Key Findings

- The size of loss carry-forwards is continuously increasing and this increase accelerates in downturn years.
- Loss carry-forwards as a percentage of GDP show large differences among countries, with some as high as 25%.
- The differences in loss carry-forwards as a percentage of GDP may reflect restrictions on the use of losses introduced by some countries.

A survey of the amounts of corporate tax losses carried forward in several countries indicates that loss carry-forwards are of a scale that could significantly reduce future government revenues. Total losses carried forward have reached a magnitude which in some cases goes as high as 25% of the gross domestic product (GDP) of a given country. Due to the fact that statistical data are originated from tax returns, the survey could not always take into full account the effects of the financial crisis and therefore the stock of losses carried forward is likely to increase even more.

The gathering of country specific data in the area of loss carry-forwards proves to be complex, as countries sometimes have different approaches in relation to the collection of data. Some countries collect data on a yearly basis, others on a multi-year basis, while in other countries data about loss carry-forwards are not collected as a matter of course. Furthermore, in many cases it is not possible to break data down by company size or industry. Another potential concern in attempting to make cross-country comparisons is that the data provided may differ between countries. For example:

- Some countries may have included types of losses other than non-capital losses;
- Austria excluded large corporate groups that have opted for its cross-border group taxation regime;
- France excluded small corporations;
- Italy only included companies that are part of the group taxation regime; and
- Norway excluded the petroleum sector.

Although the collected data are often difficult to compare, and it is therefore difficult to carry out an in-depth comparison across countries, some general conclusions may be drawn from the data provided by participating countries.¹ These conclusions relate to (i) the size of loss carry-forwards over time, (ii) the relationship between economic growth and loss carry-forwards, and (iii) the comparison of loss carry-forwards as a percentage of gross domestic product.

Size of corporate tax losses carried forward over time

The size of corporate tax losses carried forward is constantly rising.² Table 1.1 shows that tax losses carried forward rose over a period of time in all countries which provided data.

Furthermore, barring some exceptional years where the corporate tax losses carried forward decreased slightly, the table illustrates that each year there has been an increase of the stock of losses carried forward. The tax losses carried forward increased in about 80% of the cases and decreased only in about 20% of the cases.

Table 1.1. Size of corporate tax losses carried forward in certain countries for the years 2000 – 2009

| Country | Currency ¹ | Year | | | | | | | | | |
|------------------------|-----------------------|-------------|---------|---------|---------|---------|---------|---------|---------|---------|---------|
| | | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
| | | in millions | | | | | | | | | |
| Australia ² | EUR | 69 298 | 72 822 | 84 608 | 90 560 | 90 099 | 90 908 | 97 216 | 99 878 | 106 501 | 113 310 |
| | AUD | 94 802 | 99 623 | 115 746 | 123 889 | 123 258 | 124 365 | 132 995 | 136 636 | 145 696 | 155 012 |
| Austria ³ | EUR | | | | | 25 743 | 18 788 | 16 358 | 15 388 | 19 836 | |
| Canada ⁴ | EUR | 87 720 | 100 586 | 103 219 | 109 072 | 110 358 | 110 274 | 114 226 | 128 587 | 154 584 | |
| | CAD | 119 411 | 136 925 | 140 509 | 148 476 | 150 227 | 150 113 | 155 492 | 175 042 | 210 430 | |
| Denmark ⁵ | EUR | | | 4 656 | 7 097 | 11 726 | 16 087 | 18 569 | 22 098 | 30 376 | |
| | DKK | | | 34 700 | 52 900 | 87 400 | 119 900 | 138 400 | 164 700 | 226 400 | |
| France ⁶ | EUR | | | | | | | 245 000 | 255 000 | 256 000 | |
| Germany | EUR | | 380 233 | | | 473 375 | 519 370 | 576 300 | | | |
| Ireland ⁷ | EUR | | | | | | | 4 967 | 5 877 | 11 887 | |
| Italy ⁸ | EUR | | | | | 8 071 | 18 634 | 25 614 | 31 711 | | |
| New Zealand | EUR | 13 873 | 13 495 | 14 626 | 15 108 | 14 926 | 15 161 | 16 823 | 18 161 | 19 336 | 24 924 |
| | NZD | 24 386 | 23 722 | 25 711 | 26 558 | 26 238 | 26 650 | 29 573 | 31 924 | 33 989 | 43 813 |
| Norway ⁹ | EUR | | | | 30 203 | 29 326 | 29 837 | 33 524 | 38 921 | 53 091 | 51 957 |
| | NOK | | | | 238 911 | 231 976 | 236 018 | 265 186 | 307 875 | 419 967 | 410 996 |
| Sweden ¹⁰ | EUR | 32 729 | 44 986 | 54 104 | 56 687 | 53 301 | 49 758 | 50 422 | 47 990 | 63 906 | 74 938 |
| | SEK | 290 440 | 399 210 | 480 120 | 503 050 | 473 000 | 441 560 | 447 450 | 425 870 | 567 112 | 665 007 |

Notes: See page 18.

Source: Data provided by participating countries

1. For the purpose of comparability all amounts are converted into Euros. The conversion rate is the interbank rate of 31 January 2011 (www.oanda.com). Numbers in national currency are in *italics*.
2. Figures do not include capital losses. Statistics for the 2000 to 2009 income years were sourced from company tax returns processed by 31 October 2010. In Australia the taxable year is a 12 month period starting 1 July and finishing the following year on 30 June. In the table above, for reasons of comparability, the figures of an income year are listed in the column of the year the income year ended (e.g. 2008-2009 figures are listed in 2009).
3. In 2005 a cross border group taxation regime was implemented. For the years 2005 – 2008 losses of some large groups, which have opted for this regime, are not included in the table. Therefore losses for this period are expected to be higher.
4. Non-capital losses carried forward sourced from corporate tax returns assessed by 31 March 2011.
5. The table only shows tax losses carried forward from 2002 on. Tax losses of earlier years (2001 and before) could be carried forward for five years and therefore had to be used by the latest in 2006. The cumulative loss carry forward from 2002 to 2005 could therefore be higher than indicated in the table. From 2006 to 2008 the “real level” is as indicated in the table.
6. Numbers exclude very small businesses and therefore focus on companies whose turnover exceeds EUR 763 000 for sales and/or EUR 230 000 for services.
7. Figures for 2008 are provisional.
8. Losses carried forward by Italian companies that have elected the Group Taxation Regime. The data do not consider cases where the individual tax bases of the group companies have not been included in the Group tax base due to the fact that the said tax bases have been offset by ring-fenced carried-forward losses borne before the group companies had entered into the Group Taxation regime.
9. Excluding the petroleum sector.
10. Assessed deficit (accumulated) for limited companies (including banks, saving banks and insurance companies).

Relationship between economic growth and loss carry-forwards

Other interesting indications may be obtained by comparing the size of corporate tax losses over a period of time (as in Table 1.1 above) with the variations in the Gross Domestic Product (GDP) over the same period of time. Table 1.2 below shows the GDP variations for the years 2000 to 2009 in countries that provided data on the losses carried forward in the same period of time.

Table 1.2. Annual gross domestic product variations¹

| Country | Year | | | | | | | | | |
|-------------|------|------|------|------|------|------|------|------|------|------|
| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
| | in % | | | | | | | | | |
| Australia | 2.0 | 3.8 | 3.2 | 4.1 | 2.8 | 3.1 | 3.8 | 3.7 | 1.1 | |
| Austria | 3.7 | 0.5 | 1.6 | 0.8 | 2.5 | 2.5 | 3.6 | 3.7 | 2.2 | -3.9 |
| Canada | 5.2 | 1.8 | 2.9 | 1.9 | 3.1 | 3.0 | 2.8 | 2.2 | 0.5 | -2.5 |
| Denmark | 3.5 | 0.7 | 0.5 | 0.4 | 2.3 | 2.4 | 3.4 | 1.6 | -1.1 | -5.2 |
| France | 3.9 | 1.9 | 1.0 | 1.1 | 2.5 | 1.9 | 2.2 | 2.4 | 0.2 | -2.6 |
| Germany | 3.2 | 1.2 | 0.0 | -0.2 | 1.2 | 0.8 | 3.4 | 2.7 | 1.0 | -4.7 |
| Ireland | 9.7 | 5.7 | 6.5 | 4.4 | 4.6 | 6.0 | 5.3 | 5.6 | -3.5 | -7.6 |
| Italy | 3.7 | 1.8 | 0.5 | 0.0 | 1.5 | 0.7 | 2.0 | 1.5 | -1.3 | -5.0 |
| New Zealand | 2.4 | 3.5 | 4.9 | 4.3 | 3.7 | 3.2 | 0.9 | 2.9 | -1.4 | |
| Norway | 3.3 | 2.0 | 1.5 | 1.0 | 3.9 | 2.7 | 2.3 | 2.7 | 0.8 | -1.4 |
| Sweden | 4.5 | 1.3 | 2.5 | 2.3 | 4.2 | 3.2 | 4.3 | 3.3 | -0.6 | -5.3 |

1. Gross domestic product in constant 2000 prices (source: OECD.Stat, extracted on 15 February 2011).

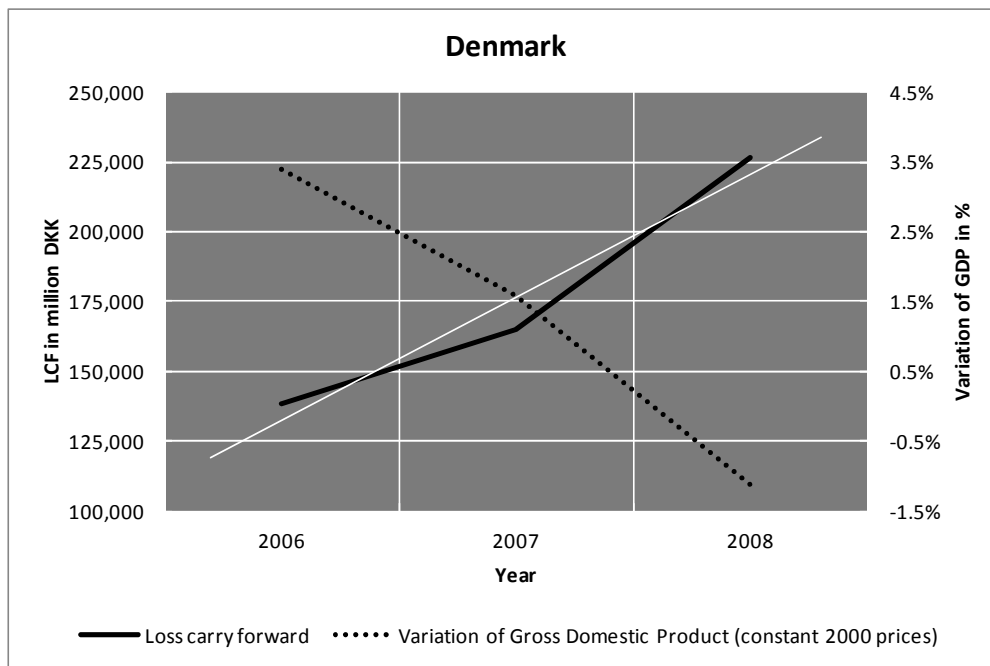
Source: Data provided by participating countries.

Although one would expect that in times of an economic upturn the stock of losses carried forward would decline, the comparison between Table 1.1 and Table 1.2 shows a different result. With the exception of the year 2009 (effects of the financial crisis), the year 2008 (where probably the first effects of the financial crisis were visible in various countries), and of the year 2003 in Germany, GDP

variations were always positive. However, the tax losses carried forward did not decrease, but instead they remained constant or rose.

In addition, the comparison between Table 1.1 and Table 1.2 shows that in years of a negative economic growth, the stock of losses carried forward increased more rapidly. For example, the trend shown in Figure 1 below regarding Denmark indicates that: (i) in years of positive economic growth (2007) the losses carried forward were still increasing, although at a decelerated rate, and (ii) in years of negative economic growth (2008) losses carried forward grew at an accelerated rate.³

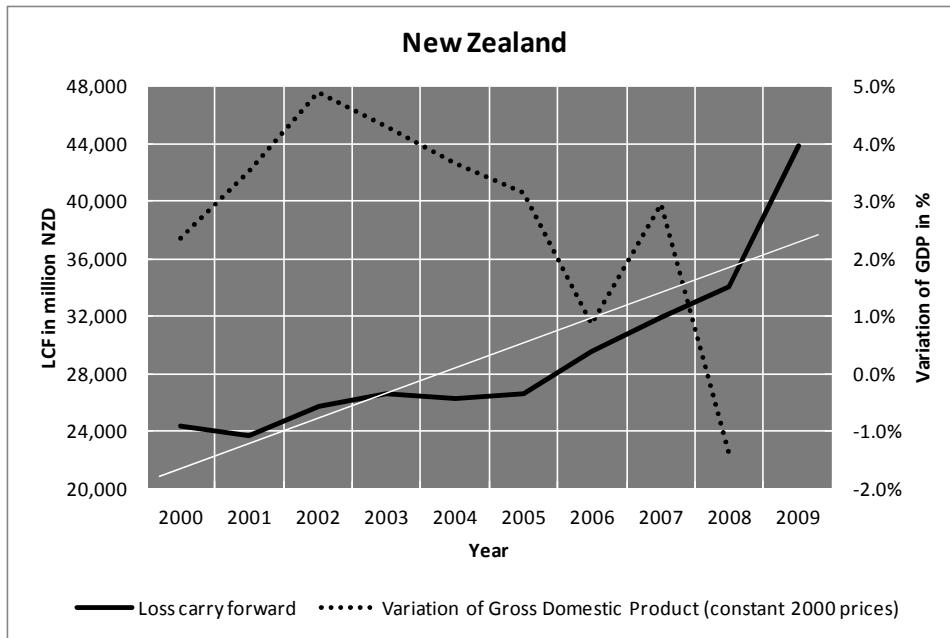
Figure 1.1. Loss carry-forward compared to variations of gross domestic product - Denmark



Source: Data provided by Denmark.

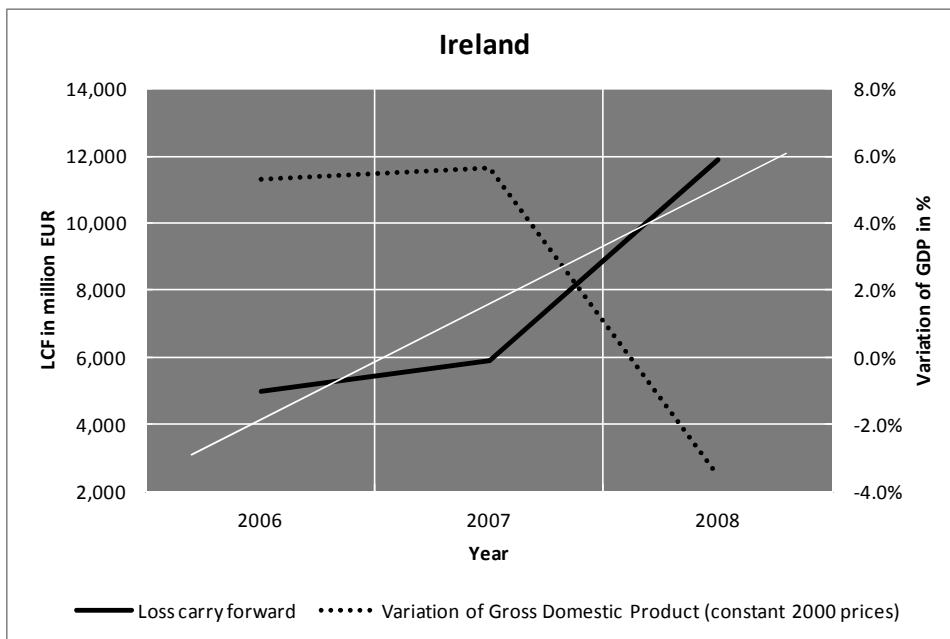
Similar indications can be gathered from Figures 1.2 to 1.4 below in relation to New Zealand, Ireland and Sweden, respectively.⁴ The figures illustrate that in years of positive economic growth the losses carried forward generally increase at a decelerated rate while in years of negative economic growth the losses carried forward increase at an accelerated rate, either directly or within a short period (in the case of New Zealand one year later in 2009).

Figure 1.2. Loss carry-forward compared to variations of gross domestic product - New Zealand

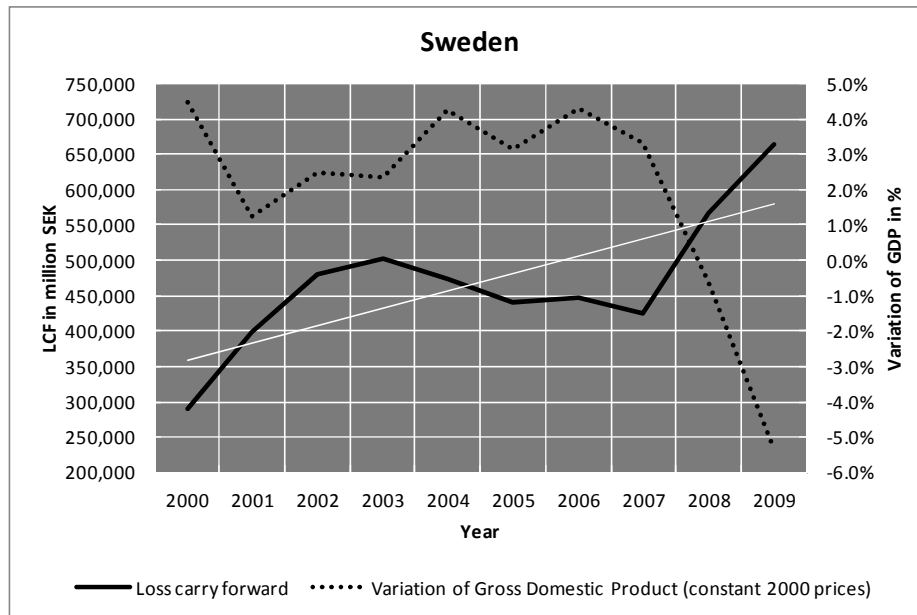


Source: Data provided by New Zealand.

Figure 1.3. Loss carry-forward compared to variations of gross domestic product - Ireland



Source: Data provided by Ireland.

Figure 1.4. Loss carry-forward compared to variations of gross domestic product - Sweden

Source: Data provided by Sweden.

Comparison of loss carry-forwards as a percentage of gross domestic product

Considering the difficulty in comparing the amounts of losses carried forward across countries, Table 1.3 below shows the losses carried forward as a percentage of the country GDP.

Table 1.3. Losses carried forward in percent of the gross domestic product¹

| Country | Year | | | | | | | | | |
|----------------------|------|------|------|------|------|------|------|------|------|------|
| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
| | in % | | | | | | | | | |
| Australia | 13.4 | 13.1 | 14.4 | 14.3 | 13.3 | 12.4 | 12.2 | 11.6 | 11.6 | |
| Austria | | | | | 11.1 | 7.7 | 6.4 | 5.7 | 7.0 | |
| Canada | 11.1 | 12.4 | 12.2 | 12.2 | 11.6 | 10.9 | 10.7 | 11.4 | 13.2 | |
| Denmark ² | | | 2.5 | 3.8 | 6.0 | 7.8 | 8.5 | 9.7 | 13.0 | |
| France | | | | | | | 13.6 | 13.5 | 13.1 | |
| Germany | | 18.0 | | | 21.4 | 23.2 | 24.8 | | | |
| Ireland | | | | | | | 2.8 | 3.1 | 6.6 | |
| New Zealand | 20.8 | 18.8 | 19.4 | 18.7 | 17.3 | 16.6 | 17.6 | 17.6 | 18.4 | |
| Norway | | | | 15.0 | 13.3 | 12.1 | 12.3 | 13.6 | 16.7 | 17.3 |
| Sweden | 12.8 | 17.0 | 19.6 | 19.8 | 17.8 | 15.9 | 15.2 | 13.6 | 17.7 | 21.5 |

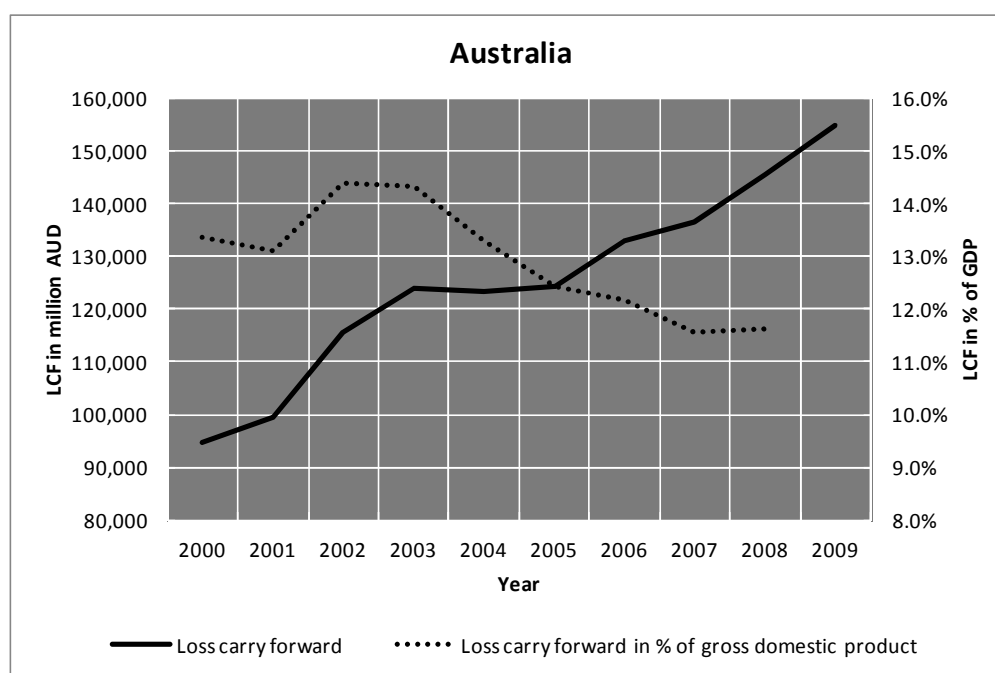
1. Gross domestic product in current prices (source: OECD.Stat, extracted on 15 February 2011). Italy is not included in this comparison (see footnotes to Table 1.1). With the exception of Canada, all countries included in the table allow unlimited carry-forward of losses.

2. The table only shows tax losses carried forward from 2002 on. Tax losses of earlier years (2001 and before) could be carried forward for 5 years and therefore had to be used by the latest in 2006. The cumulative loss carry-forward from 2002 to 2005 could therefore be higher than indicated in the table. From 2006 to 2008 the "real level" is as indicated in the table.

Source: Data provided by participating countries.

The table shows that, although there are differences among countries, the percentage of losses carried forward in relation to the GDP is often above 10%. Furthermore, it shows that only in *three* countries - Germany, New Zealand and Sweden - this percentage was or is above 20%. Another interesting aspect drawn out of Table 1.3 is that, even if the total amount of losses carried forward is rising, the percentage of losses carried forward in relation to the GDP can still be declining. Figure 1.4 illustrates this through the example of Australia, where the losses carried forward increased from AUD 94 802 million (2000) to AUD 145 696 million (2008), but at the same time the percentage of losses carried forward in relation to the GDP declined from 13.4% (2000) to 11.6% (2008).

Figure 1.5. Size of loss carry-forwards compared to loss carry-forwards in % of gross domestic product - Australia



Source: Data provided by Australia.

This indicates that if the GDP is rising at a faster rate compared to the losses carried forward and assuming that tax revenues rise at the same rate as GDP, then the actual impact of the losses carried forward on future government tax revenues may be reduced. Similar results can be found by comparing the figures of Table 1.1 and 1.3 for Austria (2005 compared to 2008), Canada (2001 compared to 2007), France (2006 compared to 2008), New Zealand (2000 compared to 2008), Norway (2003 compared to 2007) or Sweden (2004 compared to 2008).⁵

Notes

1. Data have been provided by the following participating countries: Australia, Austria, Canada, Denmark, France, Germany, Ireland, Italy, New Zealand, Norway and Sweden.
2. Inflation could be one of the factors responsible for the increase in the size of corporate tax losses carried forward.
3. Data in Table 1.1 (losses carried forward) are in actual numbers, whereas the annual gross domestic product variations are shown in constant 2000 prices. The comparison is meant to be illustrative and the reference to GDP is made to illustrate the evolution of the economic situation.
4. Diagrams for other countries comparing the loss carry forward with the variations of GDP have not been included since the data of those countries is not suitable for the above analysis. This is because either the GDP was not negative in 2008 or they did not provide data for the loss carry-forwards in 2008.
5. See Annex A for further diagrams on the size of loss carry-forwards compared to loss carry-forwards in percent of GDP.

Chapter 2

Policy Issues in the Tax Treatment of Losses

This chapter presents the different policy considerations related to the use of losses for tax purposes. It looks, in general terms, at the tax policy reasons behind various legislative choices.

Key Findings

- There are different policy considerations in relation to the use of losses for tax purposes. These policy considerations are reflected in the applicable tax systems which, on the basis of the choices made, allow, deny or restrict the use of losses for tax purposes.
- Loss carry-over is in most States subject to restrictions, generally aimed at ensuring that the loss relief is granted exclusively to the person that economically incurred the losses and at counteracting aggressive tax planning.
- Where loss offset is subject to legal restrictions, some enterprises may seek ways to circumvent these restrictions.

From a purely economic perspective, it could be argued that a loss should involve an immediate government pay-out of the tax value of the loss, or other measures that equivalently assure that the company receives the full value of the loss offsets. Nonetheless, for a variety of budgetary and administrative reasons, most tax systems place limitations on the utilisation of losses for tax purposes. An annual government payment of the tax value of losses is rarely applied. Most countries to some extent allow for losses to be offset against income economically derived by the same person across taxable periods and through different legal entities. Carry-over of losses improves the neutrality of the tax systems, and is also in accordance with the principles of economic capacity and net basis taxation. However, in practice, the majority of tax systems either do not allow losses to be carried back or allow carry-back but only for limited periods of time. On the other hand, loss carry-forward is generally allowed, with time limitations in some countries.

There are a number of policy considerations related to the use of losses for tax purposes. These policy considerations are reflected in the applicable tax systems which, on the basis of the choices made, allow, deny or restrict the use of losses for tax purposes. Where loss offset is subject to legal restrictions, some enterprises may seek ways to circumvent these restrictions. This can have negative overall effects if its outcome is in conflict with the policy choices underlying the tax system's decisions with regard to the tax treatment of losses. From a cross-border perspective, one example can be the use of the same loss in more than one jurisdiction. In order to counteract abusive schemes, an increasing number of countries provide that, generally, if losses deductible in these countries are also deductible under the rules of another country, the losses will not be deductible in the first mentioned country.

When analysing issues related to the use of losses for tax purposes it is therefore critical to understand the applicable rules and the policy choices underlying them. While this chapter describes in general terms the tax policy reasons that underlie legislative choices in relation to losses, Chapter 4 contains relevant details on participating countries' rules in relation to the tax treatment of losses.

Carry-back rules

When a loss carry-back is allowed, a company offsets losses against preceding years' income. This retroactively reduces the taxpayer's tax liabilities related to that previous year and may generate a refund of taxes previously paid. Arguments in favour of carry-back rules generally are based on the desire to ensure tax neutrality, the net taxation principle across taxable periods and the implicit support for riskier ventures (*e.g.* through R&D expenses) by well-established businesses. If, at the time the investment decision is taken, it is known that future losses can be used over time, this may have a positive impact on

the decision-makers. The possibility of using losses over time for tax purposes can also provide a macroeconomic benefit because the possibility of using the loss means that viable companies continue in operation.

Considerations against the introduction of carry-back rules may be related to governments' administrative and budgetary concerns. Indeed, a loss carry-back requires reopening a taxpayer's assessment or tax return for prior tax periods. Moreover, from a purely fiscal perspective, it creates difficulties in terms of government budgets if, in a tax year, a number of claims are raised for the refund of taxes previously paid. This is especially the case since the reason for the loss carry-backs may be a general decline in the economy, which means that tax revenues are declining just at the time when refunds will need to be granted. Based on these reasons, countries may either deny carry-back or may apply time limits to carry-back. Another reason for introducing time limitations to the possibility of carrying losses back is the so-called "principle of prescription", according to which after a certain period of time, legal rights (e.g. the right to offset the losses and receive a refund) expire.

However, a widening of the taxpayers ability to carry losses back may help to stabilise the economy. Temporary carry-back rules were introduced in several member countries in connection with the financial crisis in an attempt to stabilise the economy (see also box on page 29).

Carry-forward rules

Unlike carry-back rules, which are adopted by only a few States, loss carry-forward rules are present in the vast majority of tax systems. This may be due to several reasons including the fact that loss carry-forward rules have a more limited impact on a government's budget and are easier to administer, as they do not require the re-opening of a taxpayer's tax assessment.

In several countries time-limitations are introduced in respect of carry-forwards. Reasons advanced in support of such limitations include the principle of prescription, the fact that a company should not be loss-making for a long period of time, the need to prevent abuses, and for practical and administrative considerations. For instance, one reason for the time limit may be the difficulty of retaining information over a long period and the desire not to unnecessarily prolong the need for the tax authorities to examine the legitimacy of the loss carry-forward.

Restrictions

Loss carry-over (backwards and forward) rules are in most States subject to further restrictions, generally related to the change of ownership or activity of the entity claiming the loss relief. These restrictions are aimed at ensuring that the loss relief is granted exclusively to the person that economically incurred such losses and at counteracting aggressive tax planning schemes on losses. Restrictions on the carry-over of losses are also provided in case of total discontinuance of the company's activities and of a basic change in the company's purpose and real activities. The policy rationale for the introduction of limitations dealing with the change of activity is, in some instances, to discourage continuance of loss-making businesses. However, in many tax systems, exceptions to the application of loss carry-over restrictions are provided. Such exceptions generally relate to start-up losses, the lack of a tax avoidance motive or internal reorganisations.

Chapter 3

Country Rules on Corporate Tax Losses

This chapter summarises the main features of the rules governing corporate tax losses in the 17 countries that participated in this study. It gives an overview of relevant rules for assessing possible tax risks for revenue bodies.

Key Findings

- The complexity of country rules regarding losses and the potential opportunities for taxpayers to exploit differences among countries rules through aggressive tax planning, are themselves a source of tax risk.
- Countries which do not have any restrictions on the use of carried-forward losses in the case of mergers, acquisitions or group taxation regimes are more exposed to aggressive tax planning.
- Countries which do not have any restrictions on the use of built-in (i.e. unrealised) losses in the case of mergers, acquisitions or group taxation regimes are more exposed to aggressive tax planning.
- Several countries introduced temporary measures on the use of losses for tax purposes to support companies in the course of the global financial crisis.
- An increasing number of countries deal expressly with the dual use of losses.

This chapter of the report summarises the main features of the relevant rules in the countries which contributed to the drafting of the report. It is not intended to be exhaustive but simply to give an overview of relevant rules in relation to the tax treatment of losses for the purpose of assessing where tax risks may arise for revenue bodies.

The extent to which loss relief is available – whether against some or all of the taxpayer’s own profits of the same, previous, or later periods, or against the profits of other related companies – differs markedly from country to country. The subsequent paragraphs cover specifically the following rules: (i) sideways loss relief; (ii) group taxation regimes; (iii) carry-over of losses; (iv) use of pre-existing losses in the case of mergers, (v) losses of a foreign permanent establishment (PE); (vi) losses of a foreign subsidiary, and (vii) restrictions on dual use of losses.

Sideways loss relief

In many countries corporate tax systems are built on a net income principle, so that losses from one taxable activity can reduce the taxable income from the taxpayer’s other taxable activities. The reason for this is that generally in these countries income derived by a company is considered to be of the same type, irrespective of its source. These countries generally treat capital gains as ordinary income and therefore capital losses can offset ordinary income. However, even in these countries, in some cases capital losses on the disposal of shares and other participations which qualify for the participation exemption regime are not deductible for tax purposes (**France, Germany, Italy, the Netherlands,¹ Norway, Sweden**) or only deductible to a certain extent (**Denmark and Mexico**). In **Spain and Switzerland**, there is no restriction on the deductibility of capital losses on shares and other participations. The same is true for **Austria**, where the loss has, however, to be apportioned over a period of seven years. **New Zealand** has a “global gross” system which is closest to the net income principle. The “global gross” approach calculates net income from all sources. However, as New Zealand does not have a capital gains tax, capital gains and/or losses are excluded from the calculation of net income.

A number of countries have so-called schedular systems of taxation, according to which income and gains are divided into different categories based on their source. This is generally the case in **Australia, Canada, Ireland**, and the **United Kingdom**. In most of these countries, losses can be offset only against income from the same income source, thus preventing sideways loss relief. For example, non-trading losses can only be set off against profits from the same kind of activity and not against trading profits. However in **Ireland** and the **United Kingdom** corporate trading losses are available to be offset, sideways, against total corporate profits. Moreover, in **Australia** while non-trading losses cannot be offset against trading profits, trading losses can be used to offset non-trading gains.

Group taxation regimes

National group taxation regimes

There are different group taxation regimes in participating countries. Domestic group consolidation regimes under which profits and losses of companies belonging to the same group are aggregated and taxed on a consolidated basis are available in **Australia, Austria, Denmark, France, Germany, Italy, Mexico**, the **Netherlands, New Zealand, Spain**, and the **United States**. Group or consortium reliefs under which losses and other tax attributes may be surrendered among companies belonging to the same group are available in **Ireland, New Zealand**, and the **United Kingdom**. Systems of intra-group transfers of income under which profitable companies may transfer income to loss-making companies belonging to the same group are available in **Norway** and **Sweden**. Finally, **Canada** and **Switzerland** do not provide for group taxation regimes.

The various regimes are optional in all countries, with the exception of **Denmark**, where it is generally mandatory. Other requirements for group consolidation regimes differ markedly between countries. These include minimum shareholding requirements, minimum holding periods, whether or not a PE of a non-resident company may act as head entity of the group, duration of a consolidation election, whether the election is on an all-in basis or not, and the method of consolidation. These various features are summarised in the table below.

| Country | Type of group taxation regime | Optional | Ownership | Local PE of non-resident as head entity | Minimum duration | All-in ¹ | Degree of consolidation | Entity owning the losses | Use of losses when joining ² |
|----------------|--------------------------------|----------|------------------|---|--------------------|---------------------|-------------------------|--------------------------|---|
| Australia | Consolidation regime | Yes | 100% | No | Irrevocable | Yes | Total | Head entity | Included ³ |
| Austria | Consolidation regime | Yes | >50% | Yes ⁴ | 3 years | No | Total | Head entity | Ring-fenced |
| Canada | None | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A |
| Denmark | Consolidation regime | No | Control | Yes | N/A | Yes | Total | Loss-making company | Ring-fenced |
| France | Consolidation regime | Yes | 95% | Yes | 5 years | No | Total | Head entity | Ring-fenced |
| Germany | Consolidation regime | Yes | >50% | Yes | 5 years | No | Total | Head entity | Ring-fenced |
| Ireland | Group and consortium relief | Yes | 75% | N/A | N/A | N/A | N/A | Surrenderee company | Ring-fenced |
| Italy | Consolidation regime | Yes | >50% | Yes ⁵ | 3 years | No | Total | Head entity | Ring-fenced |
| Mexico | Consolidation regime | Yes | >50% | No | 5 years | Yes | Proportional | Head entity | Ring-fenced |
| Netherlands | Consolidation regime | Yes | 95% | Yes ⁶ | None | No | Total | Head entity | Ring-fenced |
| New Zealand | Consolidation regime | Yes | 100% | No | None | No | Total | Group | Included ⁷ |
| Norway | Intra-group transfer of income | Yes | 90% | N/A | N/A | N/A | N/A | Receiving company | Included |
| Spain | Consolidation regime | Yes | 75% ⁸ | Yes | None | Yes | Total | Group ⁹ | Ring-fenced |
| Sweden | Intra-group transfer of income | Yes | 90% | Yes | Entire fiscal year | N/A | N/A | Receiving company | Included |
| Switzerland | None | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A |
| United Kingdom | Group and consortium relief | Yes | 75% | N/A | N/A | N/A | N/A | Receiving company | Ring-fenced |
| United States | Consolidation regime | Yes | 80% | No | None | Yes | Total | Group | Ring-fenced ¹⁰ |

1. This column deals with whether all qualifying entities in a group must be included in the consolidation regime.

2. This column deals with whether losses incurred by one entity before (i) the consolidation regime was in place, (ii) the conditions for intra-group transfers of income were met, or (iii) the conditions for group or consortium relief were met, can be offset against the results of other group entities.

3. Losses transferred to the group on election may only be offset against a fraction of the head entity's income and gains.

4. If the company is resident in the EEA.

5. If the company is resident in a tax treaty country.

6. If the company's legal form is comparable to a Dutch NV or BV and it is incorporated under the law of Netherlands Antilles, Aruba, another EU Member State or a country with which the Netherlands has concluded a tax treaty containing a non-discrimination provision.

7. Subject to certain conditions, *i.e.* that continuity and commonality requirements are met.

8. For taxable periods starting on or after 1 January 2010, the 75% threshold is reduced to 70% in cases where the subsidiary is a listed company. The reduced minimum shareholding percentage also applies when the 70% interest in subsidiary entities is indirectly owned through listed companies.

9. With respect of entities leaving the group, unused carry-forward losses are reallocated to these entities according to their portion of losses.

10. If acquisition of a joining member of the group constitutes an ownership change pursuant to section 382, then only the section 382 loss limitation rule would apply.

Source: Data provided by participating countries.

In view of its particular relevance to restructuring activity in response to the crisis, it is worth setting out in more detail some of the measures applied by countries in relation to losses of companies joining a domestic group. These rules may be particularly relevant in the context of potential loss-trafficking and in more general terms in relation to the use of tax losses by entities other than those which incurred them. Losses incurred before a company joins a group consolidation regime are ring-fenced (and can therefore only be offset against the income of the entity which incurred them) in **Denmark, France, Germany, Italy, the Netherlands, Spain, and the United States**. This also applies to the **United Kingdom's** group or consortium relief regimes, with losses of a particular accounting period apportioned where appropriate on a time apportionment basis. Pre-consolidation losses can instead be used to offset the group's income in **Australia, New Zealand and Norway**. In **Sweden**, losses of a foreign company joining a domestic Swedish group are subject to a five-year temporary restriction before they can be offset against profits of other companies within the group. Several countries apply similar restrictions to built-in losses.

Cross-border group taxation regimes

Austria, Denmark, France² and Italy provide for cross-border group taxation regimes, and the main features of these are summarised in the table below.

Austria and Denmark allow a non-resident company to act as the head of a consolidated group. In **Austria** this rule applies provided that the shareholdings in the consolidated subsidiaries are effectively connected to a PE in Austria. **France and Italy** allow only resident companies to act as head of a cross-border consolidated group. **Austria** allows the taxpayer to choose which entities should be included in the consolidated group, while **Denmark, France and Italy** provide for an all-in principle where any election for cross-border consolidation has to apply to all qualifying entities. Provided the minimum shareholding requirements are met, there is full consolidation in **Denmark**, while in the case of **Austria, France and Italy** this is in proportion to the parent's share of the profits of the foreign entities.

Pre-consolidation losses are ring-fenced in **France**, and can be utilised only against the income of the company that incurred them. In **Austria, Denmark and Italy**, pre-consolidation losses are completely disregarded for purposes of the consolidation regime. On termination of the regime, either overall or in relation to a foreign loss-making subsidiary, all four countries with cross-border group taxation regimes recapture foreign losses which were included in the total income of the consolidated group.

| Country | Head entity | Ownership | All-in? | Term | Ruling | Determination of taxable income | Degree | Pre-consolidation losses | (Early) termination of the regime |
|----------------|--|-----------|---------|----------------------|--------|---------------------------------|--------------|--------------------------|-----------------------------------|
| Austria | Resident or PE of EEA company | >50% | No | 3 years | No | Austrian | Proportional | Disregarded | Recapture of losses |
| Denmark | Resident or PE of non-resident company | Control | Yes | 10 years | No | Danish | Full | Disregarded | Exit |
| France | Resident | 50% | Yes | 5 years | Yes | French | Proportional | Ring-fenced | Recapture of losses |
| Italy | Resident | >50% | Yes | 5 years ¹ | Yes | Italian | Proportional | <i>Disregarded</i> | Recapture of losses |

1. Three years for subsequent renewals.

Source: Data provided by participating countries.

Carry-over of losses

There are two types of carry-over rules: carry-back and carry-forward.

Loss carry-forward is provided in all the participating countries, while loss carry-back is only allowed in some countries. Certain countries provide for quantitative limitations on the deduction of losses carried back or forward.

A summary of the main features of country rules on loss carry-overs is included in the table below.

| Country | Loss carry-back | Loss carry-forward | Restrictions | Exceptions | Rulings |
|----------------------------|-----------------------|--|---|--|--------------------|
| Australia | No | Indefinite | Change of ownership and activity | Ownership tracing concessions apply to widely held companies | Yes |
| Austria | No | Indefinite ¹ | Change of ownership and activity | Other (non-tax) considerations | No |
| Canada | 3 years | 20 years | Change of ownership and activity | Acquisition of corporations business activities ² | No |
| Denmark | No | Indefinite | Change of ownership and other criteria ³ | Internal reorganisations | No |
| France | 3 years | Indefinite | Change of activity | No | Yes |
| Germany⁴ | 1 year | Indefinite | Change of ownership | Other (non-tax) considerations | No |
| Ireland | 1 year ⁵ | Indefinite | Change of ownership and activity | Internal reorganisations | No |
| Italy | No | 5 years ⁶ | Change of ownership and activity, mergers | Other (non-tax) considerations | Yes, in some cases |
| Mexico | No | 10 years | Change of ownership and activity, ⁷ mergers ⁸ | Inheritance, donation, internal reorganisation, merger and split off that are not considered alienations for tax purposes ⁹ | No |
| Netherlands | 1 year ¹⁰ | 9 years | Change of ownership and activity ¹¹ | Lack of tax avoidance motive | Yes |
| New Zealand | No | Indefinite | Change of ownership | Ownership tracing concessions Internal reorganisations ¹² | No |
| Norway¹³ | No ¹⁴ | Indefinite | Change of ownership and other criteria | Lack of tax avoidance motive | Yes |
| Spain | No | 15 years ¹⁵ | Change of ownership ¹⁶ | Internal reorganisations | No |
| Sweden | No | Indefinite | Change of ownership ¹⁷ | Internal reorganisations | Yes, in some cases |
| Switzerland | No ¹⁸ | 7 years | Change of ownership and restart of activity | Financial Restructurings | No |
| United Kingdom | 1 year ¹⁹ | Indefinite (against profits of the same trade) | Change of ownership and activity | Internal reorganisations | No |
| United States | 2 years ²⁰ | 20 years | Change of ownership | No | No |

1. A loss carry-forward can only offset 75% of income.

2. Losses of a corporation generally may be carried forward and back as permitted by the Act. However, to restrict abuses, "stop loss rules" were introduced to prohibit the transfer of losses by a corporation in certain circumstances. These rules generally apply in circumstances where there is a change of ownership and also in the acquired corporation's business activities.

3. These rules do not apply to financial enterprises, including banks.

4. Monetary restrictions apply to the carry-back and to the carry-forward of losses.

5. If a trade is permanently discontinued the loss may be carried-back against profits of the same trade for the previous 3 years.

6. Losses which occur in the first 3 years from the beginning of the business activity can be carried forward indefinitely.

7. After a change of control and of ownership activity, a loss carry-forward can only offset profits from the same type of activity that generated the losses if the sum of the receipts derived during the last three years is less than the accumulated losses of the company.
8. Where a merger is carried out, only the merging company can carry forward the losses it has at that moment, and only for purposes of using them against profits derived from the same trade that originated the losses.
9. These only apply in the case of change of ownership and activity not to the case of mergers.
10. Optional three year loss carry-back for losses from 2009, 2010 and 2011, for remaining losses a loss carry-forward of six years (as opposed to nine years) is allowed. The loss to be carried back is maximised at EUR 10 million per year.
11. Additional restrictions are applicable in the case of holding and group financing companies.
12. In New Zealand losses can be carried forward after an internal group restructuring if continuity and commonality requirements are met.
13. Special rules apply to the petroleum sector: carry forward of losses with interest; tax value of losses refundable on cessation of activity; tax value of losses due to exploration refundable annually.
14. In case of liquidation a two-year loss carry-back is allowed. In addition, a temporary two-year loss carry-back has been introduced for losses from 2008 and 2009.
15. For newly established companies, the 15-year carry-forward period commences as from the first tax year in which profits are made. The amount and origin of tax losses needs to be documented by the taxpayer, who bears the burden of proof, through tax returns, self assessments, accounting records and other documentary support.
16. The amount of losses available for carry-forward is reduced by the difference between the parent company's basis in the shares and the selling price.
17. After an acquisition of control of a company, the loss carry-forward is deductible only up to 200% of the acquisition price and it is not possible to use the loss carry-forward of the acquired company through group contributions during the first five years after the change of ownership.
18. One canton (Thurgau) allows a one-year loss carry-back for local taxes (§ 83 StG Thurgau).
19. If a trade is permanently discontinued certain losses may be c/b against profits of the same trade for the previous three years.
20. Generally two years but up to five years for 2008-2009 losses.

Source: Data provided by participating countries.

In view of its particular relevance, it is worth setting out in more detail some of the measures applied by countries in relation to carry-over of losses. Some countries allow losses to be carried back within a certain timeframe, as a result of which a company will receive an early cash flow benefit through repayment of tax already paid. This is for instance the case in: **Canada** and **France** (3 years), the **United States** (2 years), **Germany**, **Ireland**, the **Netherlands** and the **United Kingdom** (1 year). On the other hand, **Australia**, **Austria**, **Denmark**, **Italy**, **Mexico**, **New Zealand**, **Norway**, **Spain**, **Sweden**, and **Switzerland** do not allow the carry back of losses.

All participating countries allow losses to be carried forward against certain future profits. **Australia**, **Austria**, **Denmark**, **France**, **Germany**, **Ireland**, **New Zealand**, **Norway**, **Sweden** and the **United Kingdom** do not provide for any time limitation, allowing therefore losses to be carried forward indefinitely. In Ireland and the **United Kingdom** losses can be carried forward only against profits of the same trade. Other countries provide for a time limitation: **Canada** and the **United States** (20 years), **Spain** (15 years), **Mexico** (10 years), the **Netherlands** (9 years), **Switzerland** (7 years) and **Italy** (5 years). **Austria** limits the possibility of offsetting losses carried forward to 75% of the income. In **Germany**, only 60% of profits in excess of €1m may be offset against losses carried forward.

All countries covered in this report restrict the ability to carry losses back or forward when there is a change of ownership and/or of activity. In **Denmark**, these restrictions do not apply in the case of financial enterprises, including banks.³ **France** provides for restrictions to loss carry-over in the case of a change of activity, whether or not there is a change in ownership. **Germany**, **New Zealand**, **Norway**, **Spain**, **Sweden** and the **United States** apply restrictions in the case of a change of ownership, while

restrictions in **Australia, Austria, Canada, Ireland, Italy, the Netherlands,**⁴ **Mexico**, and the **United Kingdom** apply only if there is a change of both ownership and activity. **Switzerland** restricts the ability to carry losses forward if there is a change of ownership combined with a restart of the activity.

The determination of whether there has been a change of ownership for purposes of the relevant legislation varies from country to country. This applies for instance as regards the focus of the change, with some countries focusing on the share capital, others on voting rights, others on both. Also the relevant percentage varies among different countries, ranging from *e.g.* 30% in the **Netherlands** to 75% in **Austria**. Finally, country rules also vary in relation to the time span over which the existence of a change is evaluated. Generally, the restrictions apply only when there is a change in the direct ownership of the loss-making company, thus carving out cases where there is only an indirect change in ownership. However, the rules applicable in **Australia, Germany, New Zealand, the Netherlands** and the **United States** also cover an indirect change of ownership.

The question of what constitutes a “change in activity” for the purpose of carry-over rules varies considerably from country to country.

Some countries provide for an exception to the restrictions on the use of losses in the case of internal reorganisations. Specifically, in **Mexico**, and **Sweden** the restrictions on the carry-forward of losses do not apply for group internal restructurings. In **Spain** in the case of change of ownership, the amount of losses available for carry-forward is reduced by the difference between the parent company’s basis in the shares and the selling price. In **Denmark**, the change of ownership test applies at the level of the owners of the parent company, therefore allowing group internal restructurings. In **New Zealand** losses can be carried forward after an internal group restructuring if continuity and commonality requirements are met. In **Ireland** and the **United Kingdom**, if a trade is transferred to another company within a 75% ownership relationship, losses may be carried forward against profits of the successor company attributable to the same activities.

Some countries provide for an exception to the restrictions on the use of losses in the case where the taxpayer demonstrates that the change of ownership and/or of activity is not made for tax avoidance purposes. This is the case in **Norway**.⁵ In **Mexico**, there is an exception to the restriction regarding the change of ownership and activity (and not to one regarding mergers), in the case of inheritance, donation or an internal reorganisation, and merger or split off that are not considered alienations for tax purposes. An exception to the restriction is also provided for in the **Netherlands** in relation to certain changes in the level of trading, provided that most of the assets of the company are not passive investments.

Some countries provide for an exception to the restrictions on the use of losses for non-tax considerations, such as the maintenance of the work force of the loss making company or the investments made or to be made in the following years. Specifically, in **Germany** the forfeiture does not apply if the transfer takes place in the course of a restructuring plan in order to rescue a loss making company. Similar rules exist in **Austria** and **Italy**.

As a consequence of the recent financial crisis, a number of participating countries have introduced special measure on the carry-over of losses. These measures are summarised in the box below.

Box 3.1. Carry-Over of Losses: Crisis-Related Measures

In some countries, rules on the carry-over of losses have been amended to help companies exit the financial crisis. For example:

The **Netherlands** has introduced an optional three-year loss carry-back for losses incurred in 2009, 2010 and 2011, up to an amount of EUR 10 million per year. Any remaining losses can be carried forward for six years (as opposed to nine years).

Norway has introduced temporary provisions which give companies the possibility to carry-back losses incurred in 2008 and 2009 for two years, up to an amount of NOK 20 million per year.

The **United Kingdom** introduced a temporary extension of loss carry-back for two years, allowing a maximum of GBP 50 000 per annum to be carried back up to three years.

The **United States** introduced legislation (Worker, Home Ownership, and Business Assistance Act of 2009) that temporarily extended the net operating losses carry back to up to five years for all taxpayers except Troubled Asset Relief Program (TARP) recipients for, generally, the 2008 or 2009 taxable year.

Use of pre-existing losses in the case of mergers

Subject to certain conditions, **Austria, Canada, Italy, New Zealand, Norway** and **Spain** generally allow the transfer of loss carry-forwards from the transferring company to the receiving company in the case of a merger. This is possible also in **France** but only subject to a preliminary ministerial approval. By contrast, in **Germany** loss carry-forwards cannot be transferred to the receiving company. The same applies for **Denmark**, unless the companies were already part of the same group.⁶

Austria restricts the transfer of losses if the assets through which the losses were originated are not included in the merger and the arrangement has taken place predominantly to exploit the tax loss position.

In **Norway**, pre-existing losses cannot be carried over if one of the participating entities in a merging arrangement holds a tax position (business losses) and the merging arrangement in this regard has probably taken place predominantly to exploit the tax position (pre-merger losses). This may be the case when the company does not own assets or liabilities in connection with the losses. Furthermore if the company in question has not been performing significant business activities when the merging arrangement has taken place, the arrangement may be deemed as without any significant economic reasons, and therefore be deemed as a predominantly tax-motivated transaction that will not qualify for tax relief.

In **Canada** and **New Zealand** change of ownership rules are taken into account when deciding whether a pre-existing loss can be used following a merger. In **Canada** a wind-up or amalgamation will trigger a year end, generally resulting in the loss of one year in the carry-forward time limitations. Further, in the case of a change of control, any unrealised capital losses will be triggered by a deemed disposition of all capital assets, and will not be available for application in subsequent years. Non-capital losses may be carried forward in the successor company, subject to the time limitations as in the predecessor company. In **New Zealand** the tax treatment of pre-existing losses in the case of a merger depends on the legal form of the merger. However, as a general rule, if shareholder continuity of 49% (measured in the first instance by voting rights) is maintained for the loss-company for each year of loss, then the pre-existing losses can be carried forward and used following the merger.

Italy provides for two tests that have to be passed in order to use pre-existing losses in the case of a merger, (i) the net equity test: the carry-forward is allowed within the limit of the amount of net equity resulting from the balance sheet for the financial year preceding the shareholder resolution approving the mergers; and (ii) the vitality test which is passed if the profit and loss account of the entity whose losses are to be carried forward shows for the financial year prior to the resolution of merger revenues and labour costs higher than 40% of the average of the two prior financial years.⁷

In **Spain**, subject to certain conditions, pre-existing losses may be carried over unless such losses have already resulted, at the level of the acquiring company, in tax deductible impairment losses on equity instruments issued by the transferring company. This rule applies even if the operations are carried out for valid commercial reasons such as the restructuring or rationalisation of the activities of the companies participating in the operation.

In **France**, pre-existing losses of the transferring company can be offset against the profits of the receiving company only if there is a preliminary ministerial approval, which is generally subject to (i) the operation being justified from an economic point of view and not having been made mainly for tax purposes, and (ii) the activity which generated the tax losses is maintained during a minimum period of three years by the receiving company. In the case of pre-existing losses of the receiving company, these losses can be used against profits made after the merger, provided there is no change of business purpose or activity.

Losses of a foreign permanent establishment

The tax treatment of losses incurred through foreign permanent establishments (PEs) is generally linked to the method through which double taxation is relieved. Countries which relieve double taxation through the ordinary foreign tax credit method generally take into account profits and losses derived through a foreign PE in the determination of the taxable income of resident companies. The countries covered in this report which apply the credit method are: **Canada, Ireland, Italy, Mexico, New Zealand, Norway** (losses are not deductible if the exemption method still applies to relieve double taxation on PE income in the relevant tax treaty), **Sweden**,⁸ the **United Kingdom** and the **United States**. **Austria, Germany, and Spain** also apply the credit method when the conditions for the application of the exemption system are not met or when the taxpayer has so elected.

Subject to certain conditions, **Austria, Australia, Denmark, France, Germany, the Netherlands, Spain and Switzerland** generally apply the exemption method to relieve double taxation on foreign PE profits. The way in which the exemption method is applied varies. In **Australia, Denmark** (unless an international group consolidation regime applies), **France**⁹ and **Germany**, both foreign profits and losses are exempt and therefore foreign losses do not reduce the taxable base of a resident taxpayer. In **Austria**, the **Netherlands, Spain and Switzerland**, although foreign profits are exempt from tax, foreign losses do reduce the taxable base of resident taxpayers. In these countries, it is however provided that foreign losses which have been deducted in the residence State are recaptured in future years, *e.g.* when the foreign PE derives profits and/or when the foreign PE is alienated or converted into a subsidiary.¹⁰

Losses of a foreign subsidiary

As a general rule, losses of a foreign subsidiary are not taken into account in the State of residence of the parent company. Where an international group consolidation regime is available (**Austria, Denmark, France**¹¹ and **Italy**), losses of a foreign subsidiary may be taken into consideration insofar as an election for the application of the regime has been made. In the **United States**, profits or losses of a

foreign entity may be passed through or otherwise recognised by the US owner of a foreign entity if in the US, the foreign entity is treated as a disregarded entity, partnership, or other flow-through entity.

Where Controlled Foreign Companies (CFC) or similar rules are in force, the question arises as to whether losses incurred by the foreign entity can be deducted at the level of the resident shareholder. In general, this is often not the case: **Canada, Germany, Mexico, the United Kingdom** and the **United States** do not attribute losses of the controlled foreign entity to the resident shareholder. On the other hand, losses at the level of the CFC may affect the amount of income currently taxed at the level of the resident shareholder. In **Spain**, for example, income accrued by the CFC is attributed to the resident company at the pro rata share in the results of the CFC in cases where that income qualifies as passive income. However, such amount cannot exceed the CFC's total net income. Consequently, losses incurred by the CFC in the course of active business activities may reduce the amount of attributed passive income. Similarly, **Australia, Denmark, France, Italy, Norway** and **Sweden**, although not directly attributing the losses of the controlled foreign company to the resident shareholder, allow for the carry-forward of such losses when determining the income of the foreign entity for CFC purposes. In **New Zealand**, a CFC loss may be offset only against CFC income (or foreign investment fund income calculated under the branch equivalent method) derived from the same country. Any additional CFC loss can be carried forward to a later year against income derived from the same country. The issue does not arise in **Austria, Ireland, the Netherlands**,¹² and **Switzerland**, which have not enacted CFC rules.

Some countries (**Ireland, Sweden** – as from 1 July 2010 – and the **United Kingdom**) expressly allow for the deduction of losses incurred by a foreign subsidiary resident in an EEA country if such losses cannot be offset anywhere else.

The box below contains some further details about the tax treatment of cross-border losses under EU Law, in particular in relation to decisions of the European Court of Justice (Court) on the tax treatment of losses incurred by subsidiaries or permanent establishments. The Court has broad jurisdiction on the basis of the Treaties of the European Union and it issues decisions that are binding on EU Member States. The case law of the Court thus has far-reaching implications for the Member States' legal systems as well as their policy-making options.

Box 3.2. Treatment of Cross-Border Losses under EU Law

A number of decisions dealing with the cross-border treatment of corporate losses have been rendered by the European Court of Justice. These decisions are summarised below.

Losses of a subsidiary

Marks & Spencer (C-446/03): the Court stated that a regime of group taxation of a Member State which generally prohibits a resident parent company from deducting from its taxable profits losses incurred by a subsidiary established in another Member State, while allowing the deduction of losses incurred by a resident subsidiary, entails a restriction of the freedom of establishment provided for under the EU Treaty. However, the Court considered that this restriction is justified by overriding reasons in the public interest (namely, a balanced allocation of taxing rights, prevention of a double deduction of losses and of tax avoidance). According to the Court, the provisions at stake accomplished these objectives, but went beyond what is necessary for cases in which the non-resident subsidiary has exhausted all possibilities available in its State of residence of having the losses taken into account in the present, the past or the future, either by itself or by a third party in the event that the subsidiary has been sold.

Oy AA (C-231/05): the issue was whether or not a system whereby a subsidiary established in a Member State may deduct from its taxable income an intra-group financial transfer which it makes in favour of its parent company only if the parent company is established in the same Member State, is compatible with EC law. The Court stated that a Member State may allow a resident subsidiary to deduct a transfer of profits made under the intra-group financial transfer system only when the receiving parent company is resident in the same Member State. Although the non-deductibility of financial transfers made to parent companies of other Member States constitutes a restriction of the freedom of establishment, the Court considered that this is justified by the need to safeguard the balanced allocation of taxing rights between Member States, the prevention of tax avoidance, and it is proportionate to those objectives.

X Holding (C-337/08): the issue was whether or not a national group taxation regime, under which a resident parent company could not form a tax group with its subsidiaries resident in other Member States, while this would be possible in the case of resident subsidiaries, was compatible with the freedom of establishment. The Court ruled that EU Law does not preclude such legislation. Specifically, it stated that the group regime at issue constituted a restriction on the freedom of establishment, which was however justified by imperative requirements in the general interest, namely the balanced allocation of taxing powers. The legislation at issue was held to be proportionate to the objectives pursued, in that it did not go beyond what was necessary to achieve these objectives. The argument that a company with a subsidiary resident in another Member State should be subject to the same treatment as a company with a foreign permanent establishment, *i.e.* should be able to claim a deduction-and-recapture rule in respect of the losses of its subsidiary, was rejected.

Losses of a permanent establishment

Lidl Belgium (C-414/06): the issue was whether the freedom of establishment and the free movement of capital preclude a national tax regime, which denies a resident company the deduction of losses from permanent establishments in other Member States, while allowing such deduction in purely domestic cases. The Court considered that the legislation at stake determined a difference in treatment and therefore constituted a restriction of the freedom of establishment, which was however justified by overriding reasons in the public interest (namely, the need to ensure a balanced allocation of taxing powers and to prevent double deduction/multiple use of losses). By reference to its judgment in Marks & Spencer (C-446/03), the Court stressed that a measure which restricts the freedom of establishment goes beyond what is necessary to attain the objectives pursued where a non-resident subsidiary has exhausted all possibilities to offset, carry forward or carry back the losses incurred in the Member State where it is situated. With reference to its judgments in Oy AA, the Court emphasised that it is not necessary for all three justifications raised in the Marks & Spencer judgment to be present in order for national tax rules which restrict the freedom of establishment to be considered as justified.

Krankenheim (C-157/07): the issue was whether or not national legislation providing for the recapture of losses incurred by a foreign permanent establishment was compatible with the freedom of establishment, in particular in view of the fact that those losses had not been claimed and could not be carried forward in the

Box 3.2. Treatment of Cross-Border Losses under EU Law (cont.)

Member State where the permanent establishment was situated. The Court held that the freedom of establishment embodied in Article 31 EEA (applicable since the recapture of losses took place in 1994 when the EEA Agreement had already entered into force, and the permanent establishment State only acceded to the European Union on 1 January 1995) does not preclude such legislation. Specifically, the Court stated that the legislation gives rise to a restriction but is justified by the need to guarantee the coherence of the tax system, *i.e.* there is a direct and personal link between the two elements of the rule in question: (i) the deduction of losses incurred in a foreign permanent establishment, and (ii) the recapture of such losses up to the amount of profits made by that permanent establishment in subsequent tax years. The Court added that even if the combined effect of taxation in the two Member States concerned might lead to a restriction on the freedom of establishment, such restriction was imputable only to the Member State where the permanent establishment is situated. It added that the Member State where the head office is situated cannot be required to draw its tax rules on the basis of those in another Member State in order to ensure taxation that removes any disparities arising from national tax rules.

Restrictions on the dual use of losses

An increasing number of countries provide that, in certain specific cases, if losses generally deductible in one country are also deductible under the rules of another country, the losses will not be deductible in the first mentioned country. These rules are aimed at preventing relief being given twice for the same loss. Countries which have introduced these or similar rules include: **Denmark**, **Germany**, **New Zealand**, the **United Kingdom** and the **United States**.

In **Denmark**, legislation was introduced in 1996 to expressly prevent the deduction of the same expense in Denmark and in another jurisdiction, in situations where the related income is taxed only in one of the jurisdictions.¹³ Specifically, a Danish taxpayer is not entitled to claim an expense if: (i) that expense is claimable under foreign tax rules against income that is not included in the computation of Danish tax, or (ii) if under the foreign tax rules, the expense is deductible against income derived by affiliated companies which is not included in the computation of Danish tax.

Germany introduced specific legislation in 2001 targeting certain cases of multiple deduction of the same loss under the German group consolidation regime.¹⁴ Specifically, one of the conditions to benefit from the German group consolidation regime is that “A negative income of the controlling entity is not taken into account for domestic tax purposes to the extent it is taken into account in a foreign state in the framework of a taxation that corresponds to the German taxation of the controlling entity”. The Explanatory Memorandum which the government submitted with the bill introducing this condition states that the rule prevents, in the case of dual resident companies, losses from being taken into account twice, domestically and in a foreign country, or that losses are taken into account always at the expense of Germany because of equivalent foreign rules.¹⁵

New Zealand has a specific rule aimed at preventing the importation of losses into New Zealand. The rule states that loss-offsets can only be made if the loss company is resident in New Zealand (through incorporation or by carrying on business within New Zealand through a fixed establishment) and is not (i) treated as non-resident under double tax agreement, or (ii) liable to tax in another country through domicile, residence or incorporation. In addition, arrangements which seek to use the same loss twice within New Zealand may be subject to the general anti-avoidance rule. However, arrangements which utilise a loss both within New Zealand and another jurisdiction are unlikely to be subject to the general anti-avoidance rule, unless there is some degree of contrivance or artificiality in structuring.

The **United Kingdom** prevents certain dual resident companies from setting off their losses by way of group relief. The legislation is targeted at the sort of company typically used in abusive schemes

seeking to obtain double relief for losses. Losses or other amounts are not available for set-off under the group relief provisions if the company that would be the surrendering company is a dual resident investing company. Companies engaged in ordinary trading activities are generally excluded from the scope of the legislation.¹⁶ Below is an example of the application of the UK rules:

- A, B and C are companies in a multinational group.
- A is UK incorporated and UK resident.
- B is a dual resident investing company and is US incorporated and UK resident.
- C is US incorporated and US resident.
- A and B are members of a UK sub-group.
- B and C are members of a US sub-group.
- A and C each have profits of GBP 100.
- B has a loss of GBP 100.

Without the restriction, B could set its loss against A's profits, as well as against C's profits (and so obtain relief of GBP 200 altogether). But under the UK rules, B's loss is not available for set-off against A's profits. Without further measures, it would have been possible to avoid the effect of the loss relief restriction by transferring profits to a dual resident investing company to use up its losses without resorting to group relief. In order to keep the double deduction, the profits transferred to a dual resident investing company would have to have been taxable only in one country. This could have been achieved, for example, by transferring an asset or a trade in respect of which a capital gain or balancing charge has accrued over a period of time to a dual resident investing company under provisions relating to groups. The recipient company then realises the capital gain or balancing charge by disposing of the asset or trade to a third party. The UK therefore supplements the loss relief rules for dual-resident companies by restricting the use of six additional types of relief which are vulnerable to aggressive tax planning. The reliefs concerned all relate to capital gains or depreciation allowance provisions.

The **United States** introduced rules regarding multiple deductions of the same loss in 1986.¹⁷ The rules prevent a dual resident corporation from using a single economic loss once to offset income that was subject to US tax, but not foreign tax, and a second time to offset income subject to foreign tax, but not US tax ("double dip").¹⁸ In 1988, the application of the rules was extended to cover "separate units" of US resident corporations ("domestic corporations"), in view of situations where, for example, a domestic corporation's foreign branch or permanent establishment was allowed, under foreign law, to consolidate with the corporation's foreign affiliate thus creating the possibility of a double dip. The Internal Revenue Service (IRS) and US Treasury Department issued temporary regulations in 1989, and final regulations in 1992. In response to subsequent developments, the IRS and Treasury Department issued new final regulations under I.R.C. § 1503(d) in 2007 ("Dual Consolidated Loss Regulations" or "DCL Regulations").¹⁹

Notes

1. In the case of liquidation of the subsidiary, capital losses might be deductible.
2. The French cross-border group taxation regime is used by only a few companies (five in 2010).
3. The Danish rules on restrictions to loss carry-over in the case of change of ownership apply if there is a change of ownership concerning more than 50% of the share capital or the voting rights. When the rules apply, losses cannot be carried forward against capital income (interests, dividends, capital gains on shares and bonds, etc.) but they can still be carried forward against operating income, unless the company is an empty company without activities.
4. An exception is applicable for holding and financing companies. In that case only a change of activity is required.
5. In other words, in Norway there are generally no restrictions on the use of losses regarding change of ownership and/or activity. If however the Norwegian Tax Administration, after considering the facts in the case, finds that the tax motive was the predominate motive for carrying out the transaction, the transaction is then disregarded for tax purposes.
6. In Denmark it is also possible to have a merger with retroactive effect back to the beginning of the income year. If there is a loss in the period from the beginning of the income year until the day where the merger has been approved by all merging companies, there are restrictions on the use of this loss, unless the merging companies were part of the same group before the merger. The restriction means that the losses cannot be carried forward against capital income (interests, dividends, capital gains on shares and bonds, etc.) in the merged company. They can however still be carried forward against operating income, unless the loss-making company is a shell company without activities.
7. The tax effects of the merger can be backdated to the beginning of the tax period in which the merger is carried out but, as from July 2006, an amendment to the merger provisions has been enacted in order to clarify that, in case of backdated merger, the Net equity test as well as the Vitality test must be applied including losses generated during the tax period in which the merger is carried out.
8. Under domestic law, Sweden relieves double taxation through the credit method, which applies unless a tax treaty providing for the exemption method is applicable. The credit method is applied in the majority of the tax treaties Sweden has entered into.

9. Subject to certain conditions, since 2009 small and medium enterprises with less than 2 000 employees can deduct the losses incurred by their foreign permanent establishments. These losses are however recaptured when the foreign operations become profitable.
10. This is not the case in Switzerland when the foreign PE is alienated or converted into a subsidiary.
11. Subject to certain conditions, even in the absence of a worldwide group consolidation regime, since 2009 small and medium enterprises with less than 2 000 employees can deduct the losses incurred by their foreign 95 % owned subsidiaries. These losses are however recaptured when the foreign operation become profitable.
12. Although the Netherlands has not enacted CFC rules, it does not apply the participation exemption with regard to low tax subsidiaries which derive only passive income. In such circumstances capital gains and losses on the shares will be taxed on a yearly basis.
13. Section 5G of the Tax Assessment Law.
14. Section 14(1) No. 5 of the German Corporation Tax.
15. Government draft Gesetzentwurf der Bundesregierung Entwurf eines Gesetzes zur Fortentwicklung des Unternehmensteuerrechts of 10 September 2001, Bundestags-Drucksache 14/6882 p. 37. Available (in German) at <http://dip21.bundestag.de/dip21/btd/14/068/1406882.pdf> (as on 29 June 2009). Although the Explanatory Memorandum only refers to dual resident companies, the wording of the statute itself may also cover other cases, including certain cases involving hybrid entities. The hybrid entity cases that may be covered are cases in which the controlling entity (in particular, a German GmbH) is a corporation for German tax purposes but transparent or disregarded for foreign tax purposes. Whether such cases are covered by the rule is a subject of debate in the German tax literature.
16. Under UK law, a company is a dual resident company in any accounting period in which it is resident in the UK, under the central management and control test, if it is also within the charge to tax under the laws of a territory outside the UK by reason of certain conditions. 'Territory' is a wider term than 'country' and encompasses a state or other political sub-division. Companies engaged in ordinary trading activities are generally excluded from the scope of the legislation. This is done by defining a dual resident investing company rather than by attempting to define what is meant by a 'company engaged in ordinary trading activities'. In general a company is a dual resident investing company unless it is a trading company. However, a trading company, which is a dual resident company, will also be a dual resident investing company if: (i) it is not a trading company throughout an accounting period (for example, if its trade diminishes during an accounting period to such an extent that the company could no longer be regarded as a trading company), or (ii) although it is a trading company, it carries on activities similar to those of dual resident companies that are not trading companies.
17. I.R.C. § 1503(d), which was enacted as part of the Tax Reform Act of 1986.

18. As to the reasons for introducing § 1503(d), the General Explanation of the Tax Reform Act of 1986 prepared by the Staff of the Joint Committee on Taxation states: “Losses (however derived) that a corporation uses to offset foreign tax on income that the United States does not subject to current tax should not also be used to reduce any other corporation’s US tax. Disallowing such losses allows foreign and US investors to compete in the US economy under tax rules that put them in the same competitive position. By allowing ‘double dipping’ (use of a deduction by two different groups), the prior treatment of dual resident companies gave an undue tax advantage to certain foreign investors that made US investments. [...] Congress believed that the dual resident company device created an undue incentive for UK corporations (and Australian corporations) to acquire US corporations and otherwise to gain an advantage in competing in the US economy against US corporations. Similarly, the dual resident company device created an undue incentive for US corporations to acquire foreign rather than domestic assets” (JCS-10-87, 4 May 1987, pp. 1064-1065).
19. TD 9315, Federal Register Vol. 72 No. 52 of 19 March 2007, pp. 12902-12946.

Chapter 4

Schemes Involving Tax Losses

This chapter summarises schemes concerning tax losses that have been encountered in the 17 countries that participated in this study. It identifies key risk areas in relation to losses, including the use of financial instruments, corporate reorganisations and non-arm's-length transfer pricing.

Key Findings

- Participating countries have encountered a number of aggressive tax planning schemes on losses.
- These schemes aim at achieving a variety of results, such as shifting profits or losses to related or unrelated parties, circumventing restrictions on the carry-over of losses, circumventing rules on the recognition or treatment of losses, creating artificial losses, and claiming multiple deductions for the same loss.
- Financial instruments, corporate reorganisations and transfer pricing are the techniques commonly used to achieve these different results and have been identified as key risk areas by revenue bodies.
- Some instruments identified by participating countries, such as after-tax hedges, may pose difficult policy questions.

Overview

Where governments give tax relief for commercial losses in a way which is broadly symmetrical with the taxation of profits, taxpayers may be encouraged to engage in aggressive tax planning, treating country restrictions on loss carry-over as technicalities to be sidestepped rather than as a fundamental policy prohibition on loss relief. Further, aggressive tax planning to create “artificial” tax losses in profitable years only reinforces governments' concerns about aggressive tax planning on real, commercial, losses.

This chapter summarises schemes on losses which have been encountered in participating countries. Based on these schemes, it also identifies key risk areas in relation to losses. These key risk areas include the use of financial instruments (*e.g.* derivatives, sale and lease back arrangements, special classes of shares, etc.), corporate reorganisations (*e.g.* mergers, acquisitions, transfer of assets, exchange of shares, transfer of residence, etc.), and non-arm's length transfer pricing. Needless to say, financial instruments, corporate reorganisations, and intra-group transactions are generally made for sound business and economic reasons. However, in some cases they can be used inappropriately to allow an unintended use of losses for tax purposes.

Key risk areas

Financial instruments

The use of financial instruments to circumvent the rules regarding the tax treatment of losses is an area of concern for revenue bodies. The use of complex financial instruments or schemes involving more than one jurisdiction poses challenges to revenue bodies, particularly in terms of being able to obtain all relevant information. In this respect, international co-operation among revenue bodies plays a key role in ensuring that the underlying business reasons for the transactions, and their effects in the different jurisdictions involved, are well understood.

Financial instruments can for example be used to shift profits or losses among different taxpayers, thus allowing taxpayers to make use of their losses upfront or to circumvent time-limitations and/or change of ownership/activity restrictions. Participating countries have also identified a number of

schemes where financial instruments are used to create artificial losses, *i.e.* losses which are only generated for tax purposes with no economic loss incurred anywhere by anyone. These arrangements typically seek to create expenses or losses to offset other income, generally avoiding the taxation of any corresponding gain or profit. Finally, financial instruments have been used to obtain multiple deductions of the same loss, an area of great concern for revenue bodies.

Corporate reorganisations

Chapter 4 of this report shows that most countries have rules restricting the use of losses in cases of changes of ownership and/or of activity, although some contain exceptions for internal reorganisations. These restrictions limit the tax revenue costs of loss relief, though may also in some cases be directed specifically at counteracting abusive practices where losses are trafficked and loss-making companies are acquired primarily for tax purposes, thus helping to prevent tax-driven distortion of economic decisions. The same applies to most countries' rules on group taxation, which deter tax-driven mergers and acquisitions by ring-fencing losses within the entities (or group of jointly-owned entities) which incurred them.

Revenue bodies are already examining the tax consequences of changes of ownership and reorganisations due to the recent crisis in order to ensure compliance with the applicable rules. Cases which raise concerns from the perspective of revenue bodies are for example the acquisition of a loss-making company for the sole or main purpose of merging it or including it in the tax group with profit-making companies, thereby reducing the profits of other group companies by the losses of the acquired company. Other techniques which raise concerns are related to the acquisition of loss-making companies towards year-end, before losses materialise for tax purposes. Some participating countries have noticed an increase in such acquisitions, which may be due to the fact that restrictions on the carry-over of losses or on the use of losses in the different forms of group taxation regime in some cases do not apply in relation to parts of a tax period.

Non-arm's length transfer pricing

Transfer pricing is a key risk area in international taxation, both in profit-making and loss-making contexts. Specific transfer pricing challenges may arise in the case of loss-making groups and of loss-making affiliates within profit-making groups. Revenue bodies verify the consistency with the arm's length principle of the remuneration of cross-border transactions that a taxpayer conducts with foreign affiliates,¹ and/or of the profit allocation to a PE of a foreign entity.²

Under the arm's length principle, the remuneration of a subsidiary or profit allocation to a branch that is part of a multinational group has to reflect the functions performed, taking into account the risks assumed and the assets used by it. In a loss-making environment, revenue bodies may want to verify in particular that the allocation (or reallocation) among the members of the group of functions, assets and/or risks, carrying significant profit/loss potential is consistent with the arm's length principle. In most sectors, the allocation of risks within a group has a very important and distinct role in profit/loss allocation and revenue bodies are monitoring whether losses are allocated where the risks related to them belong. Guidance on the application of the arm's length principle to risk allocation and risk transfers can be found in Chapter IX of the OECD Transfer Pricing Guidelines and in the report on the Attribution of Profits to Permanent Establishments.

There are concerns that responses might be hasty and create tax inefficiencies. Of special concern are the tax-motivated changes of the entrepreneurial structure and purported changes in the transfer pricing policy of the group. Many multinational companies have implemented central entrepreneur

structures in order to streamline their supply chain on a regional or global basis. In the banking sector, in the years before the financial crisis, some banks were managing large financial assets through foreign operations located in low-tax jurisdictions. Due to the crisis, large losses have materialised in relation to these financial assets. Revenue bodies are concerned that in some cases these loss-making financial assets may be allocated to relatively high-tax jurisdictions, through non arm's length transactions or dealings.

In other sectors, entities acting as central entrepreneurs are usually located in favourable tax jurisdictions, with low-risk manufacturing and distribution taking place in high-tax jurisdictions. The tax effect of these structures is therefore that the bulk of any profits arising from these activities are allocated to the entrepreneur, with the low-risk entities in the group receiving a constant but low remuneration. This would also mean that in recessionary business conditions, the central entrepreneur may suffer losses, while the low-risk affiliates located in high-tax countries remain profitable. In such a situation, some MNEs may be tempted to change established transfer pricing policies or to amend existing intercompany agreements to allocate the losses throughout the supply chain.

The application of the arm's length principle is critical to ensure that transfer (mis-)pricing is not used to transfer losses to profitable entities within the group, or to countries whose loss relief rules are relatively more generous. Transfer pricing risks can potentially arise for instance from the misallocation of income/expenses within a multinational group, or from the over-pricing or under-pricing of transactions. Transfer pricing concerns have also been identified in some participating countries in relation to financial transactions, for example non arm's length prices for guarantee fees and related party interest rates, and after-tax hedges (*i.e.* arrangements under which on a pre-tax basis one party has a net long exposure, whereas the counterparty has an identical net short exposure. On an after tax basis, however, they have no exposure, since the exposure is effectively passed to the revenue authority).

Issues also arise with split hedges – *i.e.* where a company in country A holds a hedging instrument in relation to an asset or liability of an associated company in country B, thus hedging the exposure for the benefit of the group as a whole. Such split hedges are common in international banking groups, and the transfer pricing analysis would have to examine the situation where, as a result of a hedging strategy, losses can be recognised for tax purposes in a jurisdiction other than that in which the gain from an offsetting position is recognised. As noted in the report on the Attribution of Profits to PEs,³ this raises difficult issues where the split hedges occur between associated enterprises and will be the subject of future work. In the meantime, general guidance on transactions which purport to transfer risk from one associated enterprise to another can be found in the in Chapter IX of the OECD Transfer Pricing Guidelines. Particular problems also arise where financial institutions use “net” hedging strategies so that it is almost impossible to trace the gain or loss from any particular transaction to the offsetting gain or loss on the customer transaction it hedges.

Schemes encountered by participating countries

Tax authorities are concerned by the risk to tax systems posed by taxpayers who use aggressive tax planning schemes, and these concerns apply in principle to tax planning involving losses in the same way as to tax planning involving profits. Tax planning techniques for companies with accumulated losses, or for profitable companies in a position to benefit from widespread losses elsewhere may however be quite different from the tax planning techniques which would normally be used in good times. For example, the fact that many groups are simultaneously in a tax loss position may offer unusual opportunities for back-to-back arrangements with unrelated competitors to maximise the loss relief of each party. Differences between the rules for loss relief will also increase incentives for tax planning which secures tax relief in the country with the most favourable rules. Relative incentives to have taxable income

allocated to a relatively high or low tax jurisdiction are also clearly reversed in a period of losses compared with a period of profits.

Based on their intended result, schemes encountered by participating countries have been divided into the following categories:

- loss-shifting schemes;
- schemes shifting profits to a loss-making party;
- schemes circumventing time restrictions on the carry-over of losses;
- schemes circumventing change of ownership/activity restrictions on the carry-over of losses;
- schemes circumventing rules on the recognition or treatment of losses;
- schemes creating artificial losses; and
- schemes involving the dual/multiple use of the same loss.

Loss-shifting schemes

A number of loss-shifting schemes have been encountered by participating countries. These schemes intend to transfer losses to profit-making operations, thus allowing the recipient to use the losses against its taxable income. Loss-shifting schemes encountered by participating countries are based on the use of complex financial instruments such as swaps and after-tax hedges, non-arm's length transfer pricing, and the acquisition of a loss-making company with no other asset than the tax losses carried forward. Examples of these schemes are briefly summarised below.

The following scheme (although more complex in the real case) was identified by one participating country in relation to banks: Bank A is resident in high-tax Country A. Bank B is resident in high-tax Country B. Both banks operate in Country C (a low-tax jurisdiction) through subsidiaries, respectively Sub Bank A (belonging to the Bank A group) and Sub Bank B (belonging to the Bank B group). Both subsidiaries manage large loss-making financial assets. Sub Bank A and Bank B enter into a financial derivative contract (a credit default or an equity swap depending on the underlying assets) which transfers the Sub Bank A's exposure in respect of its financial assets to Bank B. At the same time, Sub Bank B and Bank A enter into a similar financial derivative which transfers the Sub Bank B's exposure in respect of its financial assets to Bank A. Finally, Bank A and Bank B enter into a similar financial derivative which effectively neutralises, on a group consolidated basis, the transfer of the risks between Bank A Group and Bank B Group. In other words, the transaction does not modify the consolidated exposure in respect of the financial assets that the two banking Groups had before the transaction, while at the same time losses are allocated for tax purposes in the high-tax jurisdictions Country A and Country B.

Another arrangement identified by several participating countries involves a group of related companies entering into offsetting long and short positions in index-linked securities which could result in the transfer of unusable tax losses incurred in one jurisdiction to a related profitable party in another jurisdiction. Although the movement in the underlying index cannot be predicted with certainty, the terms of the arrangement are that – at worst – the group emerges in a neutral (no gain/no loss) after-tax position, whereas if the index moves within the bounds of market expectations, gains will arise in the loss-making company and be used against the losses carried forward, while losses will arise in the profitable company, where they will reduce the tax payable on that company's other profits.

Another scheme seeks to import losses into one participating country through the transfer of the risk management function in relation to certain “out of the money” currency swaps from a foreign branch of the same foreign bank to the local branch in that participating country, while the accounting function in relation to the assets stays with the foreign branch. As a result, the local branch is treated as the economic owner of the financial assets from the time of the transfer of the risk management function and obtains a deduction for payments made in relation to the swaps entered into by another branch. In addition, all realised gains and losses from the time of the transfer are included in the assessable income and deductible from the assessable income of the local branch.

In another scheme Company X acquires all shares in Company Y at the end of year 1. Before the sale of the shares, the inventory and personnel of Company Y were transferred to an associated company. The only remaining item is losses amounting to *e.g.* 500. The sale price of the shares has been agreed to 8% of the losses reported until year end, thus 40. In year 2, Company Y received 500 from Company X in the form of a group contribution. The group contribution is treated as taxable income at the level of Company Y (and is used to offset its losses) and as deductible at the level of Company X. In year 3, Company Y pays 500 as tax-exempt dividends to Company X. Thereafter, Company Y liquidates. The result of the transactions is that Company X has a net benefit of 100 equal to the tax value of the contribution made (*i.e.* 28 % of 500=140) minus the price paid for the shares (*i.e.* 40).

In a scheme identified by one participating country, a resident parent company (“Parent”) with taxable profits has several wholly-owned subsidiaries (“Subsidiaries”) in the retail trade in other participating countries which have been adversely affected by the recent economic downturn. These subsidiaries acted as distributors and have incurred large operating losses due to major sales declines. Parent makes large payments to Subsidiaries and claims these payments as deductions for so-called “market support payments”. However, these amounts are not substantiated by any pre-planned marketing strategies but are simply aimed at transferring losses back to Parent, so they can be fully utilised for tax purposes.

Schemes shifting profits to a loss-making party

Another group of schemes identified by participating countries aims at shifting profits to loss-making operations so as to allow an upfront use of the losses. In some cases, revenue bodies have encountered schemes where entities with loss-making activities have been allocated highly mobile income (such as income from financing or licensing of intangibles) so as to be able to offset their losses against this income, despite the fact that they were not carrying out the economic activity giving rise to the income. Other schemes identified by participating countries seek to use the losses of related parties against profits from the sale of assets to unrelated third parties. In other schemes, the business of the taxpayer is restructured so that, through a chain of trusts, its income purportedly passes on to a loss company. Examples of these schemes are briefly summarised below.

One participating country has encountered a situation where a company which is part of a group (the Group) and resident in Country A has large losses due to the financial crisis. The Group has conducted an internal restructuring in order to utilise the losses in Country A. This involved a transfer of group companies in Country B to a group company in Country C. The Country C group company financed its acquisition of the Country B companies through an intra-group loan advanced by the Country A company, which can in this way use the interest received on the loan against its losses. On the other hand, the Country C group company deducts the interest it pays from its taxable income. In a similar scheme identified by another participating country, taxable income was purportedly shifted through licence payments.

One participating country identified a scheme which relies on the interposition of a related loss-company in the sale of assets to unrelated third parties. Specifically, following the (tax-free) transfer of assets to the related loss-company in exchange for shares, the loss-company sells the assets at their fair market value to an unrelated company, thus offsetting the gain made on the sale with its existing loss carry-forward. Subsequently, either the loss company renders an inter-company loan to the company originally owning the asset, or it distributes a dividend that may be tax exempt under the existing domestic rules. As a result, the scheme avoids taxation of the appreciation in the value of an asset and permits tax-free access to the proceeds received.

Another scheme uses a trust arrangement to shift profits to an unrelated loss company. In that scheme, the business of the taxpayer is restructured so that its income purportedly passes through a chain of trusts on to a loss company, so that the loss offsets the income and no tax is due. The income, less an amount for promoter fees, remains effectively under the control of the taxpayer or associates and in some cases is never actually distributed to the loss company.

Schemes circumventing time restrictions on the carry-over of losses

Participating countries have identified certain schemes which rely on the use of financial instruments to “refresh” losses that would otherwise be lost due to the application of time restrictions in participating countries. In other words, they create taxable income, generally in the last period in which the loss carry-forward can be used and a loss in the following period, thus circumventing the applicable time restrictions. In other cases, schemes are based on purported reorganisations in order to benefit from an extended carry-back period under the relevant legislation. Examples of these schemes are briefly summarised below.

The following scheme was identified in a country where losses may be carried forward only for a limited period of time: a taxpayer buys shares in a foreign company which is expected to pay dividends in the last period in which the loss carry-forward can be used. The taxpayer then sells the right to receive the dividends, thus realising income upfront which could be used against the expiring loss carry-forward. The shares are then alienated in the following year and the reduction in value of the shares is recognised for tax purposes thus effectively refreshing the loss carry-forward and avoiding the application of the time limitation under the relevant law.

In other schemes, the taxpayer tries to circumvent the rules on the carry-over of losses through a reorganisation. One such scheme builds on the fact that under the applicable rules while losses of an ongoing trade or business can (generally) be carried back only to the preceding tax year, they can be carried back to the three preceding tax years in case of a permanent discontinuance of the trade or business. The scheme seeks to trigger the application of these provisions without discontinuing the business and without an effective change in ownership. By transferring the loss-making business to a newly created partnership controlled by the same group but where a small partnership interest (*e.g.* 1%) is held by an individual, trust or other person which is not a company within the charge to corporation tax, it is argued that the introduction of the individual (or other person) causes the trade to be permanently discontinued for purposes of these rules.

Schemes circumventing change of ownership/activity restrictions on the carry-over of losses

Schemes circumventing change of ownership/activity restrictions on the carry-over of losses identified by participating countries involve for example the injection of income into a loss-making company immediately prior to a major shareholding change which would result in the loss-making company forfeiting its loss carry-forwards. Income injections may take place either by transferring high-

mobile income or through the use of financial instruments. In addition, some participating countries have identified the use of shares with different participating rights as a tool to circumvent the applicable limitations on the use of losses in the case of change of ownership limitations. Examples of these schemes are briefly summarised below.

One participating country has identified schemes designed to refresh accumulated losses of a company facing forfeiture of those losses due to a failure to maintain shareholder continuity throughout the required period. One scheme involves the sale of an intellectual property belonging to a profitable operating company to a related loss company. The asset is subsequently licensed back to the operating company for a long period of time in return for royalties. The key to this scheme is that for the first five years, the royalties are paid in a lump sum and thus the losses that would otherwise be forfeited are extinguished and shifted to the operating company.

Another scheme involves Company A, a new wholly owned subsidiary of Company B (Company C), and a new wholly owned subsidiary of Company B (Company C). Before the shareholder continuity breach, Company B issued mandatory convertible notes (“MCNs”) to Company A in exchange for cash. The MCNs had a set term and coupon rate, and converted to equity at term. Company A then assigned the right to the interest income on the MCNs to Company C, in exchange for an upfront fee. The intended result of the transactions is that (i) the fee is treated as income received by Company A before the shareholder continuity breach and offset against Company A’s accumulated losses, and (ii) post the continuity breach the group receives a net deduction equal to the (interest income assignment) fee.

In one scheme identified by another participating country, the taxpayer has used shares with different voting rights to avoid the application of the relevant limitations on the ability of an acquiring company to use the losses of the acquired company. Through this scheme, the taxpayer seeks to avoid a “change of control” event which would trigger these limitations, thus seeking to reduce the taxable income of the acquiring company by using the relevant group taxation regime.

Schemes circumventing rules on the recognition or treatment of losses

Participating countries have identified a number of schemes aimed at circumventing the rules on the recognition or treatment of losses for tax purposes. These schemes aim for example at circumventing the rules on the use of losses for group taxation purposes, the deductibility of foreign losses, or the carry-over of losses. Examples of these schemes are briefly summarised below.

In one scheme, shortly before year-end a non-resident holding company creates a PE in one participating country and the PE records the participations in several profit and loss-making local subsidiaries on its balance sheet. As a consequence, the non-resident claims that the profits and the losses of the resident subsidiaries must be consolidated for tax purposes. This claim was made despite the fact that the relevant conditions for consolidated group taxation had not been met as the PE did not control the subsidiaries for the required period, the shares were not effectively connected to the PE, and it did not carry on a business activity in the participating country.

In other cases, revenue bodies have noticed an increase in the acquisition of loss-making companies towards year-end, before losses materialise for tax purposes. This involves the acquisition before the end of a taxable period of a company that has “built-in” (latent) losses. Where there are no rules limiting the deduction of losses incurred during the fiscal year in which the change of ownership occurs, the acquiring company can then make use of the available group taxation regime to offset the acquired company’s losses against the profits of other group companies.

In a scheme identified by one participating country, intra-group dividends were distributed with the sole aim of using losses incurred before the application of the relevant consolidation regime. Specifically, according to the applicable group taxation regime, losses incurred before a company joins a consolidated group are ring-fenced and can only be set off against profits made by the consolidated group up to the amount of profits made by the subsidiary which carries the losses forward. At the same time, intra-group balances, transactions, income, and expenses are not taken into account for purposes of determining the taxable income of the consolidated group. In one scheme, one group company distributed dividends to the group company carrying the losses forward and the taxpayer claimed that the losses could be used to offset the group's taxable income up to the amount of the dividends received by the loss-making company, even if the dividends were not ultimately taken into account to determine the group taxable income.

In another case, the taxpayer claimed the application of the group/consortium relief regime to buy part of the losses (which could not otherwise be used) of an unrelated company. Specifically, a resident company that anticipates a significant trading loss in the future is sold by the parent company to a newly created company (Newco). Newco has two classes of shares and an outside investor acquires the class of shares which provides the investor with 26% of the voting rights in Newco. The parties therefore form a consortium and when the loss arises the members of the consortium can claim a share of those losses through the applicable consortium relief rules, which enables losses to be surrendered to companies outside of the original group.

In a scheme identified by one participating country, a corporate reorganisation took place to allow losses arising from the activities of a foreign group company to be offset against the income of a resident group company. Specifically, the foreign group company sold its assets to the resident group company and offset the gain realised on the sale against its existing losses in the foreign country. The resident company then claimed that the purchased assets in the foreign country amounted to a permanent establishment through which its activities were carried on in the foreign country. Since the activities in the foreign country kept generating losses, the resident company claimed that these losses were deductible against the company's taxable income in the participating country.

Similar issues have been encountered in other participating countries. In one scheme, a resident company with a loss-making PE in another EU Member State is converted into a partnership. For the latter State's taxation purposes, as a result of the conversion, the PE is considered to be liquidated and subsequently re-established. The effect is that the hidden reserves of the PE are considered to be realised and the resulting income is offset against the loss carry-forward of the PE. Concurrently, the resident company claims in his tax return a deduction for the remaining loss carry-forward of the PE from its income referring to a decision of the European Court of Justice (*Lidl Belgium GmbH and Co. KG*) according to which the country of the head office must allow the deduction of the foreign PE losses when they become "definitive" and cannot be used anywhere else. In addition, in the financial year following the conversion, the PE amortises goodwill and sets up a reserve, causing a significant loss and thus shifting the loss carry-forward from the terminated to the re-established business.

Schemes creating artificial losses

Schemes creating artificial losses are those where the taxpayer seeks to generate losses for tax purposes with no economic loss incurred anywhere by anyone. These schemes are therefore different from the ones described above which seek to use losses which have been economically incurred somewhere, by the same taxpayer or by a different one, in ways not intended or contrary to the principles underlying the relevant rules. Artificial loss schemes often rely on complex financial instruments such as securities lending, equity swaps, and sale and repurchase agreements ("repos") on shares. Other schemes

identified by participating countries seek to generate artificial losses through tax-driven internal reorganisation or through the exploitation of domestic merger rules. Examples of these schemes are briefly summarised below.

Under a securities lending agreement, a foreign entity typically lends foreign shares to the taxpayer, who in turn agrees to pay an amount (the “manufactured payment”) equal to the dividends received during the term of the agreement, less a fee. Dividends paid to the taxpayer are usually excluded from taxation under the participation exemption regime applicable in many States, while the taxpayer can claim a deduction for the payment made to the foreign entity under the agreement. Depending on the tax treaty in force between the taxpayer’s State of residence and the State of residence of the foreign entity receiving the “manufactured payment”, there may not be any withholding tax on the “manufactured payment”. Similar results can also be obtained under equity swaps and repo agreements.

Other schemes identified by participating countries seek to reduce the taxable base through intra-group debt in tax-driven internal reorganisation. One scheme identified by one participating country relies on a debt-financed intra-group sale of shares in an operating company to create interest deductions used to offset operating income. The debt funding is provided by a group company. The transaction is structured such that the gain on the sale of the shares is not taxable and that there is no or little tax on the interest income. A similar scheme, based on circular financing through a cross-border zero-coupon was identified by another participating country: a resident company finances a foreign subsidiary with equity and subsequently borrows from it, under a zero-coupon note arrangement. The scheme benefits from the fact that interest on a zero-coupon note is deductible on an accrual basis in the participating country, whereas for foreign tax purposes it is taxable on a cash basis, and that cash is never actually paid. A third country may also be involved for purposes of winding up the arrangement.

Other artificial loss schemes aim at creating deductible goodwill via an intra-group sale of a foreign subsidiary, followed by the conversion into a transparent entity. Specifically, in one scheme identified by one participating country, a resident company part of a multinational group forms a foreign limited partnership (“X LP”) to which it sells the shares in its subsidiary resident in the same foreign country. The subsidiary is itself converted into a limited partnership (“A LP”) and subsequently A LP is merged into X LP. A 99% interest in X LP is held by a group company resident in the participating country. The sale followed by the conversion is intended to create deductible goodwill and to allow the resident group company to claim tax deductions against its other income. A similar scheme has been found in another participating country, where certain corporate reorganisations are tax-free.

Another scheme exploits a domestic law provision which, in a “short-form amalgamation” (a specific merger procedure), requires the shares in the merging entity to be cancelled for no consideration. In other words, the merger is considered to be a disposal of shares, which results in a loss for the respective shareholder. The loss is artificial because the taxpayer still holds the participation, although in the acquiring company and not in the acquired one. This scheme has been successfully challenged in court.

Finally, one participating country identified a scheme which aims at creating an artificial deduction through a series of transactions. First, the taxpayer enters into an intra-group alienation of assets which generates a capital gain at the level of one group member and a corresponding increased tax base for depreciation purposes at the level of another group member. Subsequently, an unrelated bank creates artificial interest deductions for the taxpayer through a chain of loans. The tax liability on the capital gain is thus offset through interest payments on a loan purportedly made to acquire participations generating exempt dividend income. The scheme involves a number of offshore companies and it appears that there are no underlying cash flow movements.

Schemes creating multiple deductions for the same loss

An area of concern for participating countries is the multiple deduction of the same loss. This result may be achieved through different means. One is for example the possibility of deducting capital losses on the shares of a subsidiary while the subsidiary's loss can also be deducted in future years. Multiple deduction of the same loss is most often achieved through hybrid mismatch arrangements, *i.e.* arrangements exploiting differences in the tax treatment of instruments, entities and transfers between two or more countries.

As regards the first type of schemes, in one scheme Company A bought 85% of the shares of Company B. In the same year, Company B incurs a loss which is carried forward, for which Company A claims a depreciation deduction on the value on the shares. In the following year Company A and Company B merge, Company B being the transferred company and Company A taking over the loss carry forward. In a subsequent year, Company A uses the loss carry-forward to offset profits, thus using again the loss of Company B. At the outset of a similar scheme, the taxpayer seeks to use the losses of an associated loss company by either making a contribution to its capital or a shareholder loan that is to be waived later, thus increasing the tax value of the shares accordingly. The contribution has no influence over the lower fair market value of the shares. A subsequent sale of the shares to an associated company creates a loss at the level of the selling company, because the fair market value is lower than the acquisition costs of the shares, which includes the contribution (or waived shareholder loan). In another scheme, the taxpayer seeks to create two deductions for the same loss by relying on the relevant tax consolidation regime. Losses incurred by subsidiaries during the period that they are included within the consolidated group can be set off against profits of the consolidated group but as a general rule adjustments made during consolidation must be reversed upon de-consolidation. The taxpayer tried to use this general rule to claim two deductions for the same loss.

Schemes on hybrid mismatch arrangements exploit inconsistencies which may allow the taxpayer to deduct the same initial loss in more than one jurisdiction. In practice, the following schemes are frequently used by taxpayers:

- **Dual-resident companies:** where one State bases its determination of corporate residence on where a given company is incorporated, while the other State treats a company as a resident where it is centrally managed or controlled. A company could therefore be resident in both states. If the domestic tax rules of both States allow resident companies to benefit from a group taxation regime, a loss-making dual-resident company could deduct its losses twice – once against the taxable profits of one group, and once against the taxable profits of another, thus resulting in a double benefit for the worldwide group in respect of the same initial loss.
- **Hybrid entities:** where different entity classification rules in different countries may create multiple deductions for the same loss. This may for example be the case where a debt-funded acquisition vehicle (either a partnership or a corporation) is treated as non-transparent in the country in which it is organised and as transparent in the country of residence its members. The debt-funded vehicle may then offset its interest expenses against the income of other group companies resident in the same country under the relevant group taxation regime. At the same time, the interest expense may also be deducted against the income of the members in their country of residence. Schemes of this sort have been identified by many participating countries. The same result can also be achieved through the use of an hybrid instrument between the hybrid entity and the acquired company, in particular when no group taxation regime is available in the country where the hybrid entity is organised.

- **Branch models:** where interest expenses attributable to a branch are deducted both in the country of the branch and in the country of residence of the company of which the branch is a part. This is because in many cases losses attributable to a foreign branch are available to offset income of a resident corporation. At the same time the branch may also deduct the interest expense against the income of other companies resident in the country where the branch is located through the relevant group taxation regime.
- **Double-dip leases:** where the taxpayer takes advantage of the interaction of rules of different States concerning depreciation deductions. The States involved consider that depreciation deductions in respect of business assets should be given to the owner of the asset. In one State, the owner is considered to be the one who holds the legal title to the asset, while in the other State it is considered to be the person who has the economic ownership of the asset. If a taxpayer resident in one State grants a lease over an asset to a taxpayer resident in the other State, thereby giving him the full economic ownership of the asset, the acquisition costs of the asset may be fully deductible in both States involved. Where accelerated depreciation is available on the assets for tax purposes, this may give additional upfront tax benefits to the taxpayers involved.

Notes

1. For treaty situations, see Article 9 of the OECD Model Tax Convention.
2. For treaty situations, see Article 7 of the OECD Model Tax Convention.
3. See Paragraph 138 of Part III of the 2008 report on the Attribution of Profits to Permanent Establishments.

Chapter 5

Strategies for Detecting Schemes Involving Tax Losses

This chapter examines strategies employed to detect aggressive tax planning schemes involving tax losses. It offers a general overview of detection strategies and looks at those employed by the 17 countries that participated in this study.

Key Findings

- Audits and disclosure initiatives play an important role in detecting ATP schemes on losses.
- Disclosure initiatives which have proven to be very useful in helping tax administrations detecting schemes on losses in a timely manner include: special reporting obligation on losses, mandatory disclosure rules, rulings and co-operative compliance programmes.
- Data analysis, including the use of the ATP Directory, has often contributed to the detection of ATP schemes on losses.
- Some countries have started using predictive models on the future use of losses, both as a revenue-forecasting tool and as an indicator of aggressive tax planning on losses.
- Countries usually apply several detection strategies simultaneously.

Overview

This chapter deals with strategies used to detect aggressive tax planning schemes involving tax losses. After having described detection strategies in general terms, it summarises the specific detection strategies which were used by participating countries in relation to the schemes described in Chapter 5. The term “detection strategy” is used very widely and includes, for instance, the types of information gathering powers put at the disposal of the tax administration.

In general terms, detection strategies can be divided into five main categories: (i) strategies, whether designed as detection tools or not, that cause taxpayers or third parties to provide relevant information to the tax authorities (Disclosure and reporting), (ii) strategies where the tax administration is not in the role of a “passive” recipient of information but is in an active role seeking to detect relevant information by using its investigative powers (Investigations and audits), (iii) strategies that seek to build on information held either by other government departments or that involve co-operation with the tax administration of another country (Domestic and international co-operation), (iv) strategies that seek to make the best use of internal tax administration information or external public data (Data analysis), and (v) strategies not covered otherwise (Other detection strategies).

Disclosure and reporting

These strategies rely on mechanisms that either require or invite taxpayers or third parties to provide relevant information to the tax administration. The report “Tackling Aggressive Tax Planning Through Improved Transparency and Disclosure – report on Disclosure Initiatives” outlines the importance of timely, targeted and comprehensive information, provides an overview of the disclosure initiatives introduced in certain OECD countries, discusses the usefulness of such initiatives, and contains a number of conclusions and recommendations.¹

Disclosure and reporting initiatives which have proven to be useful in relation to aggressive tax planning schemes on losses include: special reporting obligation on losses, mandatory disclosure rules, rulings and co-operative compliance programmes.

Special reporting obligation on losses

Certain countries have rules which oblige the taxpayer to communicate to the tax administration specific information regarding tax losses. For example, Australia and the United States provide for a separate schedule in the tax return form. In Spain there are rules which require the taxpayer claiming a loss offset to produce the relevant accounting records and documentation for the year where the loss was claimed.²

In Italy, in the case of participations not qualifying for the participation exemption, capital losses that exceed EUR 5 million must be notified by non-IAS taxpayers to the tax authorities in order to assess the possible tax avoidance profile of the transaction; in the absence of such notification, the capital loss is not deductible. In addition, taxpayers are obliged to report losses exceeding EUR 50 000 arising from the disposal of shares and other securities similar to shares (*e.g.* shares and other securities issued by foreign companies whose payments are treated as dividends for tax purposes) listed on Italian or foreign regulated markets. These obligations allow the tax administration to identify potential ATP schemes. Italy has detected aggressive tax planning schemes on losses and directed its audit strategy based on the special reporting obligation on losses mentioned above.

Mandatory disclosure rules

Mandatory disclosure rules are currently in place in a number of participating countries, such as Canada (where a substantial revision is currently under consideration), Ireland, the United Kingdom (revisions are currently under consideration) and the United States. These regimes serve a similar purpose: to provide the tax administration with early information on certain ATP schemes and their users and thereby allow for a faster and more effective response. Other countries are actively considering the introduction of mandatory disclosure rules. All mandatory disclosure regimes have to address a number of design questions which determine their scope and application. At a very basic level, the regimes need to specify who has to report what and when. The regimes further need to spell out the consequences of non-disclosure and will also need to manage the expectations and explain the consequences of making disclosures for taxpayers.

In the United Kingdom, a number of schemes have been disclosed under the Disclosure of Tax Avoidance Scheme Regulations under the hallmark relating to “premium fees”. It is also worth mentioning that a number of mandatory disclosure rules mention aggressive tax planning schemes on losses as a specific category of schemes to be disclosed to the tax administration. This is for example the case in Canada (“any acquisition of property for which representations are made that the losses or deductions in the first four years will exceed or equal the cost of property”), Ireland (“Loss schemes”), the United Kingdom (“Loss schemes”) and the United States (“Loss Transactions”).

Rulings

All participating countries have some form of advance ruling mechanism. These ruling mechanisms are not primarily designed to detect aggressive tax planning schemes but they can nevertheless generate relevant intelligence. They can also be used to influence taxpayer behaviour and in this sense operate as both a detection and a response strategy. Three countries (Australia, the Netherlands, and New Zealand) have product rulings³ and a number of other countries (*e.g.* Italy and France) have special ruling regimes relating to the application of general anti-avoidance or abuse provisions. In addition to product rulings, Australia also provides class rulings to taxpayers. Class Rulings have been introduced to enable the Commissioner to provide legally binding advice in response to a request from an entity seeking advice

about the application of a relevant provision to a specific class of entities in relation to a particular scheme. Interestingly, several countries have detected schemes on losses through ruling requests.

Co-operative compliance programmes

Co-operative compliance programmes encourage responsible tax reporting and discourage aggressive tax planning on the part of taxpayers. Initiatives aimed at establishing a fruitful and effective dialogue with the taxpayer are very useful in addressing the main compliance issues from the perspective of the tax authorities, and these also carry important benefits for the taxpayer in terms of the greater certainty which comes from real time working with the tax authority. The objective of encouraging the growth of relationships of this kind is to create a joint approach to improving tax risk management and overall tax compliance, with benefits for both parties. Countries that have engaged in such initiatives generally do so as one important component of a wider compliance strategy which encompasses a balance between guiding and supporting risk management by taxpayers, alongside audit and other enforcement actions.

Participating countries that have developed business models aimed at improving tax risk management and compliance by large business taxpayers through greater co-operation include Australia (Annual Compliance Arrangement), Ireland (Co-operative Approach to Tax Compliance), Italy (Risk Management Monitoring), the Netherlands (Horizontal Monitoring), New Zealand (Co-operative Compliance Initiative), Spain (Forum for Large Taxpayers), Sweden (Co-operative Compliance Model for Large Taxpayers, CCM), the United Kingdom (Tax Compliance Risk Management Process) and the United States (Compliance Assurance Process).

Countries where such programmes are in place have reported that a number of schemes on losses have come to their attention through voluntary disclosures made by taxpayers under such programmes. In several instances, following discussions with the relevant tax authorities, these schemes have not been implemented by the taxpayer. In some countries, taxpayers have undertaken the commitment not to use aggressive tax planning schemes. This is in some cases based on written agreements with the relevant authorities, *e.g.* through Codes of Tax Practices and the like.

Investigations and Audits

Many countries provide their field auditors with specific guidelines and defined target areas to focus their audit activities. Countries which have a national office generally have a process in place that allows information to flow from the audit function to the national office. The disadvantage of audits as a means for detection is that they relate to past years and that, given ever-shrinking staffing resource, the gap between tax audits is getting longer. For these reasons, it is often the case that the intelligence gained from audits does not enable tax administrations and policy-makers to implement timely response strategies.

Investigations and audits have been used for the detection of the vast majority of the schemes analysed in the previous chapter. Tax audits have in some cases been initiated due to the large deductions claimed by taxpayers in their tax returns or large amounts of losses carried forward. In some countries, corporate reorganisations and major shareholding changes are generally considered high tax risks in all large company audits.

Domestic and international co-operation

The detection of ATP schemes may require the co-operation with other governmental departments or, where relevant information is not available from domestic sources, co-operation with foreign authorities. Domestic co-operation in the detection of ATP schemes comes in different forms, such as sharing of information and co-ordinated or joint investigations with anti-money laundering authorities, financial regulators, and other governmental departments.

International co-operation, mainly through exchange of information, is an important tool in the detection of ATP schemes. Spontaneous information exchange is often cited as the form most likely to lead to the detection of ATP schemes. Recognising the importance of spontaneous exchange of information, several countries have adopted an information exchange policy pursuant to which they provide information spontaneously under double taxation conventions in cases in which ATP schemes appear to have a negative impact on the tax base of the treaty partner. In addition, there are several initiatives incorporating elements of international information exchange and focusing on aspects of aggressive tax planning, such as the OECD ATP Directory,⁴ and the Joint International Tax Shelter Information Centre (JITSIC), an initiative of various tax administrations designed to supplement their ongoing work in identifying and curbing perceived abusive tax avoidance transactions, arrangements, and schemes.

Some participating countries have reported that when they have identified aggressive tax planning schemes on losses they have used international co-operation to inform the competent authority of other countries about schemes involving tax losses. Other countries have also mentioned that without international co-operation, it would have been extremely difficult, if not impossible, to understand the mechanics of certain schemes.

Data analysis

Using, comparing and analysing various sources of information can be an important strategy for detecting ATP schemes on losses, promoters and potential or actual users. The success of data analysis depends on the breadth and depth of the data available to the tax administration and its ability to process, compare and match the data to produce meaningful results. The data may come from both internal sources (*i.e.* information already held by the tax administration) or from external sources (*i.e.* publicly available information, information available on commercial databases, etc.). The information gathered in this way is often analysed in a wider “risk profiling” process. Data analysis with respect to a large number of taxpayers is often assisted by (and may sometimes require) a high degree of computerisation. The use of the ATP Directory has also contributed to increase the awareness of schemes on losses within tax administrations.

Certain schemes on losses have been identified through media or law firms’ publications or tax alerts. Internet searches have also proven to be useful. In other cases, schemes have been detected through an analysis of the information regarding interest expenses contained in the tax returns of the taxpayer concerned. SEC filings available on the internet have also been used to ascertain whether certain complex financial instruments had been subscribed by a related party: since there was no comment concerning the instruments on the consolidated accounts of the group, it was concluded that they had been subscribed by another company part of the consolidated group.

Some countries have started using predictive models on the future use of carried forward losses as a revenue-forecasting tool and as an indicator of aggressive tax planning on losses. The methods used to forecast losses and the scope of the models vary. One participating country has developed a predictive

loss utilisation model which predicts the proportion of carried forward losses arising in a tax year that will be utilised in each of the next three income years. This model is based on real GDP growth.

Other detection strategies

A number of countries focus their initiatives also on promoters. Targeting the “distribution channel” may in many cases deliver results more quickly and in a more cost effective way than strategies that focus exclusively on the “end-user”, *i.e.* the taxpayer (see also *Conclusions and Recommendations* in relation to response strategies focusing on promoters/third parties).

Notes

1. See http://www.oecd.org/document/46/0,3746,en_2649_34897_46987758_1_1_1_1,00.html
2. It is worth mentioning that this requirement is largely formal, does not permit a full audit and the tax authorities may therefore be unable to confirm or cross-check the information with the third parties because third parties are not obliged to keep their records more than a certain period of time.
3. A “product ruling” is any ruling which is intended to be relied upon not just by the person requesting the ruling but by any person or any persons in a specified class that may invest in a particular “product” (*i.e.*, the ruling “attaches” to the product not to a particular taxpayer). Unlike a private ruling that would only apply to the entity that requested the ruling, a product ruling applies to any entity within a specified class that chooses to enter into the scheme described in the ruling.
4. The ATP Directory is a secure OECD on-line platform for sharing non-taxpayer specific information on aggressive tax planning schemes, so as to improve the response time to emerging global tax risks, trends and patterns already identified and experienced by some revenue bodies, and to share experiences in dealing with them.

Chapter 6

Strategies for Responding to Schemes Involving Tax Losses

This chapter presents response strategies to aggressive tax planning schemes. It looks at strategies that deny or limit the tax benefits of aggressive tax planning schemes, other strategies that influence taxpayer behaviour, and strategies that target promoters and other intermediaries.

Key Findings

- It is important to have a comprehensive approach focusing on supply, demand and products.
- General and specific anti-avoidance rules are often used to deny benefits to taxpayers in relation to aggressive tax planning schemes on losses.
- Early engagement between taxpayers and tax authorities through co-operative compliance programmes has resulted in additional intelligence, in some schemes not being implemented by the taxpayer and in reaching early resolution of potential tax disputes involving losses.
- Mass media (“one-to-many”) approaches play an important role for influencing taxpayers’ and promoters’ behaviour regarding tax compliance.

Overview

This chapter deals with strategies used to respond to aggressive tax planning schemes involving tax losses. After having described response strategies in general terms, it summarises the response strategies which were used by participating countries in relation to the schemes included in Chapter 5. The term “response strategies” is used in a narrow sense and does not include strategies that relate to issues of organisation and management or scheme detection. However, where particular strategies have multiple effects, this part discusses those effects that do not relate to scheme detection (*e.g.* the deterrent effect of certain mandatory disclosure rules for tax avoidance schemes).

In general terms response strategies can be divided into three main categories: (i) strategies focused on denying or limiting the tax benefits for which ATP schemes are used (*e.g.* general anti-avoidance rules and doctrines, specific anti-avoidance rules and doctrines, approaches to the interpretation of tax statutes and regarding the burden of proof), (ii) other strategies to influence taxpayer behaviour, and (iii) strategies focusing on promoters/third-parties.

Strategies denying or limiting tax benefits

Negating, or at least limiting, the tax advantage that taxpayers try to achieve with a particular scheme is an obvious answer to aggressive tax planning. The main means used to deny the intended tax consequences in cases of aggressive tax planning schemes on losses are (i) interpretation of the relevant tax provisions, (ii) general anti-avoidance rules and doctrines, and (iii) specific anti-avoidance rules.

Interpretation of the relevant tax provisions

The interpretation of the relevant tax provisions has sometimes been used to deny the benefits from aggressive tax planning schemes on losses. For example, in a scheme where shares in loss-making and profit-making companies were allocated to a local permanent establishment of the non-resident parent company so as to be able to claim group relief was responded to by denying the tax benefits at stake based on the following reasons: (i) the PE did not “control” the companies from the beginning of the taxable period; (ii) the shares could not be considered as effectively connected to the PE, and (iii) no business activity was carried on through the PE.

In other cases, the relevant scheme has been tackled through a proper application of the arm's length principle: in one scheme where loss-making operations were purportedly transferred to a foreign branch of a resident company in order to claim a deduction in the latter country, the tax authorities considered that a permanent establishment or branch needs to be responsible for the activities purportedly carried out through the permanent establishment or branch. In the case of a sale and lease-back with an advanced upfront royalty payment, transfer pricing rules have been taken into account to evaluate the consistency with the arm's length principle.

Finally, in a scheme where the importation of tax losses had been claimed through an inflated amount of goodwill in the course of a corporate reorganisation, the scheme has been countered by assessing the amount of the goodwill at a lower amount and by increasing the length of the depreciation period.

General anti-avoidance rules

General anti-avoidance rules are often used in relation to the schemes described in Chapter 5. Loss-shifting schemes, schemes transferring profits to loss-making companies and other schemes on losses have chiefly been counteracted through the application of these rules or doctrine. For example, in one participating country the substance-over-form doctrine has been used in relation to circular financing transactions aimed at creating an artificial interest deduction. Consequently, a transaction named zero-coupon loan was not regarded as a loan and what had been booked and deducted as interest on the zero coupon note was not regarded as deductible interest. The same approach was taken in a similar scheme which relied on a debt-financed intra-group sale of shares in an operating company to create interest deductions used to offset operating income.

As regards schemes based on financial instruments such as repos, stock lending and similar transactions, countries concerned have applied a variety of response strategies, including the relevant general anti-avoidance provisions. In other cases, an "abuse of law" doctrine has been applied, sometimes successfully also before the local courts. Similarly, schemes using financial instruments in order to accelerate income production before a major shareholder change have been countered through general anti-avoidance rules. Finally, in cases where it is difficult to apply the relevant transfer pricing rules due to the fact the parties to the transactions are unrelated to each other, the tax authorities have also reverted to general anti-avoidance rules or principles. Lacking specific anti-avoidance rules, general anti-avoidance rules have also been used in relation to schemes exploiting the use of losses through domestic group taxation regimes.

Specific anti-avoidance rules

Specific anti-avoidance rules are often an effective tool to respond to aggressive tax planning schemes on losses. This may be because they are expressly targeted at certain avoidance schemes which have been encountered by the relevant authorities and for which it was necessary to introduce a legislative change.

For example, schemes which have been tackled through remedial legislation include those where there has not been any real cessation of the trade but it is claimed that a cessation occurs as a result of the trade being transferred to a person or persons outside the scope of corporation tax in order to make an unintended use of the losses. This remedial legislation states that in these circumstances and provided it can be established that this is part of a scheme or arrangement one of the main purposes of which is to access the relevant "terminal loss" relief, such relief will not be available to the transferring entity, nor

will carried forward losses be transferred to the receiving person or persons for set off against future profits.

Some countries have introduced specific anti-avoidance rules in relation to loss-shifting schemes. In Australia, any company's tax losses or deductions may be affected by domestic law provisions according to which the Commissioner can reverse the effect of schemes that in order to avoid tax, bring together in the same company assessable income and tax losses, current year deductions, or deductions for bad debts, that apart from the scheme would not be fully used.

Other specific anti-avoidance rules in relation to loss-shifting schemes provide for adjustments to the basis of property in certain types of corporate reorganisations and tax-free transfers of property. Similar rules are applicable to the basis of partnership property and are mandatory in cases where the partnership has a substantial built-in loss immediately after the transfer of a partnership interest.

Specific anti-avoidance rules have also been introduced in relation to schemes circumventing the rules on the use of pre-existing losses for group taxation purposes. In some countries when determining the amount of losses made before a company joined the group that could be set off against the income of other group members, no restrictions applied to exclude intra-group dividends from the calculation of the profits made by members of the consolidated group. The law was then amended to exclude intra-group dividends from the calculation of the limit of pre-consolidation losses that could be used at the level of the group.

As regards schemes creating artificial losses through financial instruments such as repos, stock lending and similar transactions, countries concerned have applied a variety of specific anti-avoidance provisions. For example, some provisions deny the benefits of these schemes by denying the exemption on the dividends received by the "borrower" if the shares are not held for a minimum period of time or if the "lender" would have not been entitled to such exemption. Other specific anti-avoidance provisions instead target the deduction side of the scheme by denying the deduction of "manufactured payments" made under the scheme or payments made to purchase rights on shares whose dividends benefit from an exemption.

Schemes claiming the multiple deduction of the same loss have generally been countered through the application of specific anti-avoidance rules in countries which have them. As mentioned in Chapter 4, several countries have rules which directly impact on multiple deduction schemes, generally denying the deduction of an expense when the same expense is also deductible in another country. Those countries have been able to successfully apply these rules in a number of cases

Strategies to influence taxpayer behaviour

Apart from denying or limiting achievable tax advantages, countries use a number of other strategies to discourage taxpayers from engaging in aggressive tax planning. Disclosure obligations and other relevant reporting obligations have already been discussed in Chapter 4 of this report. Although their primary purpose is to provide the tax administration with information, they also influence the taxpayer's decision on whether to engage in aggressive tax planning or not. Penalties are a classic way to influence behaviour and are also used as a response strategy in the area of aggressive tax planning. Settlement initiatives, especially those announced publicly, can be a way to encourage taxpayers to come forward, to disclose their participation in aggressive tax planning schemes and to help save costs and resources for both the tax administration and the taxpayers involved.¹

Co-operative compliance programmes which are based on establishing and fostering mutual trust between taxpayers and tax authorities encourage responsible reporting positions for tax purposes, thus moving taxpayers away from the use of aggressive tax planning schemes. At the same time, co-operative compliance programmes may be helpful in reaching early resolution of potential tax disputes involving losses and can also directly benefit commercial operations and recovery from the crisis in the case of genuine commercial losses. In fact, commercial losses are by their nature a signal of distress and early resolution of claims on tax losses can be crucial in securing cash-flow benefits for taxpayers, including through repayment or offset of tax otherwise payable. Co-operative compliance programmes also generate additional intelligence within the tax administration in relation to ATP schemes. Better information leads to more effective tax risk assessment and more appropriate resource allocation.

Taxpayer alerts, notifications and wider communication strategies are also an effective tool for influencing the behaviour of taxpayers. Through such initiatives, tax authorities send targeted messages to a particular audience, expressing their opinion with respect to a particular scheme. Generally, in these communication tools tax administrations set out the nature of the scheme and the concern that the revenue body has with it. These "One-to-many" approaches have often been used in relation to loss schemes and have proven to be effective in countries which use them, *e.g.* Australia, New Zealand, Sweden, the United Kingdom and the United States.

The Australian Taxation Office (ATO) regularly issues Taxpayer Alerts which serve as an early warning on tax planning issues or arrangements that the ATO has concerns about and that are under risk assessment. Taxpayer Alerts inform taxpayers that the Commissioner is currently reviewing the described arrangements and indicate in general terms the issues the Commissioner may have with the scheme.²

The New Zealand Inland Revenue issues Revenue Alerts which provide information about significant and/or emerging tax planning issues that are of concern to Inland Revenue.³ It has also successfully employed a Property Compliance Project to promote coverage of the risk, greater public awareness and education. The programme included a mix of outbound calling, advertising, media interviews/articles, brochures and direct mails in order to raise awareness, which were used tactically to treat known and well-defined loss risks.

The **United Kingdom** tax authorities issue alerts called "Spotlights" which provide some advice on tax planning to be wary of, list some indicators that the tax authorities see as suggesting that a scheme may involve tax avoidance and which are likely to be investigated.⁴

In the **United States**, a scheme can be identified as a "listed transaction" or a "transaction of interest" (*i.e.* a transaction designated by the Internal Revenue Service in published guidance as subject to special disclosure requirements) and the Internal Revenue Service issued a "Coordinated Issue Paper" on the transaction. Although co-ordinated issue papers are not official pronouncements on the issues, they do set forth the tax authorities' current thinking.

Joint audits, which represent a new form of co-ordinated action between and among tax administrations, may also play an important role in influencing taxpayers' behaviours.⁵ Revenue bodies around the world, in pursuit of stronger international tax compliance, are moving beyond co-operation to various forms of co-ordinated action. In a joint audit, two or more countries would join to form a single audit team to conduct a taxpayer examination. In addition to shortening examination processes and reduce costs, joint audits should result in quicker issue resolution, more streamlined fact finding and more effective compliance. In other words, they have the potential to serve as both detection and response strategies in relation to aggressive tax planning schemes.

Promoter/third-party focused strategies

These strategies recognise that ATP schemes often have one or more intermediaries who gain financially from designing, marketing or providing other forms of relevant assistance in connection with such arrangements. Such strategies may in many cases deliver results more quickly and in a more cost-effective way than strategies that focus exclusively on the taxpayer. While a number of the strategies discussed in the preceding chapters will also have an indirect discouraging effect on promoter behaviour, a number of countries have introduced measures with a more direct impact on the behaviour of third parties like promoters. For example, several countries apply penalties on promoters of aggressive tax planning schemes, require promoters to disclose aggressive tax planning schemes and also impose penalties for failure to disclose such transactions. The “one-to-many” approaches mentioned above in relation to strategies to influence taxpayer behaviour may play an important deterrent effect also in relation to promoters/third parties.

Notes

1. Settlement initiatives could therefore also be described as a detection strategy.
2. See <http://www.ato.gov.au/atp>
3. See <http://www.ird.govt.nz/technical-tax/revenue-alerts>
4. See <http://www.hmrc.gov.uk/avoidance/spotlights.html>
5. See <http://www.oecd.org/dataoecd/10/13/45988932.pdf>

Conclusions and Recommendations

Countries' strategies have to operate within the broader context of their tax system, administrative practice and culture. It is up to each country to decide how to approach the issues addressed in this report and what strategies would be the most appropriate in the context of, and the most consistent with, its rules and framework. It is against this background that this report reaches the following conclusions and recommendations.

Conclusions

In relation to the size and the policy issues of the tax treatment of corporate tax losses, the report concludes that:

- Although it is difficult to collect data on a consistent basis, the study shows that the size of loss carry-forwards is constantly increasing and this increase accelerates in downturn years.
- Loss carry-forwards as a percentage of GDP show large differences among countries, with some as high as 25%. These differences in loss carry-forwards as a percentage of GDP may reflect restrictions on the use of losses introduced by some countries; they may also to some extent simply reflect measurement differences in the data provided by various countries.
- There are different policy considerations in relation to the use of losses for tax purposes. These policy considerations are reflected in the applicable tax systems which, on the basis of the choices made, allow, deny or restrict the use of losses for tax purposes.
- Loss carry-over is in most States subject to restrictions, generally aimed at ensuring that the loss relief is granted exclusively to the person that economically incurred the losses and at counteracting aggressive tax planning.
- Where loss offset is subject to legal restrictions, some enterprises may seek ways to circumvent these restrictions.

In relation to country rules regarding corporate tax losses, the report concludes that:

- The complexity of country rules regarding losses and the potential opportunities for taxpayers to exploit differences among country rules through aggressive tax planning, are themselves a source of tax risk.
- Countries which do not have any restrictions on the use of carried-forward losses in the case of mergers, acquisition or group taxation regimes are more exposed to aggressive tax planning.

Countries which do not have any restrictions on the use of built-in (*i.e.* unrealised) losses in the case of mergers, acquisitions or group taxation regimes are more exposed to aggressive tax planning.

- Several countries introduced temporary measures on the use of losses for tax purposes to support companies in the course of the global financial crisis.
- An increasing number of countries deal expressly with the dual use of losses.

In relation to aggressive tax planning schemes on losses, the report concludes that:

- Schemes detected by participating countries aim at achieving a variety of results, such as shifting profits or losses to related or unrelated parties, circumventing restrictions on the carry-over of losses, circumventing rules on the recognition or treatment of losses, creating artificial losses, and claiming multiple deductions for the same loss.
- Financial instruments, corporate reorganisations and transfer pricing are the techniques commonly used to achieve these different results and have been identified as key risk areas by revenue bodies.
- Some instruments identified by participating countries, such as after-tax hedges, may pose difficult policy questions.

In relation to detection strategies, the report concludes that:

- Audits and disclosure initiatives play an important role in detecting ATP schemes on losses; data analysis, including the use of the ATP Directory, has also proven to be useful in detecting ATP schemes on losses. Countries usually apply several detection strategies simultaneously.
- Some countries have started using predictive models on the future use of losses as a revenue-forecasting tool and as an indicator of aggressive tax planning on losses.

In relation to response strategies, the report concludes that:

- It is important to have a comprehensive approach focusing on supply, demand and products.
- General and specific anti-avoidance rules in relation to loss schemes are often used to deny benefits to taxpayers.
- Early engagement between taxpayers and tax authorities through co-operative compliance programmes has resulted in additional intelligence, in some schemes not being implemented by the taxpayer and in reaching early resolution of potential tax disputes involving losses.
- Mass media (“one-to-many”) approaches play an important role for influencing taxpayers’ and promoters’ behaviour regarding tax compliance.

Recommendations

Based on these conclusions, and building on the work of the Aggressive Tax Planning Steering Group and of the Forum on Tax Administration, this report recommends countries to:

- consider exploring, through Working Party No.2 of the Committee on Fiscal Affairs, the reasons for the results outlined in Chapter 2 of this report and any improvements required to country techniques for the collection of data on losses;
- consider introducing or revising restrictions on use of losses, including built-in losses, in cases of mergers, acquisitions, or group taxation regimes, to the extent they are concerned with aggressive tax planning on the use of losses in these cases;
- consider introducing restrictions on the multiple use of the same loss to the extent they are concerned with these results;
- evaluate the economic and revenue impact of temporary measures on the use of losses for tax purposes with a view to deciding whether or not those measures should be abolished, extended or made permanent;
- analyse the policy and compliance issues of schemes such as after-tax hedges and evaluate the options available to address them;
- continue to share relevant intelligence on aggressive tax planning schemes on losses, their detection and response strategies, and measure the effectiveness of the strategies used, for example in terms of additional tax revenue assessed/collected, or in terms of enhanced compliance;
- consider the introduction of co-operative compliance programmes, where appropriate to a country's circumstances, based on the benefits to both taxpayers and tax administrations;
- consider the introduction or the revision of disclosure initiatives targeted at aggressive tax planning schemes on losses.

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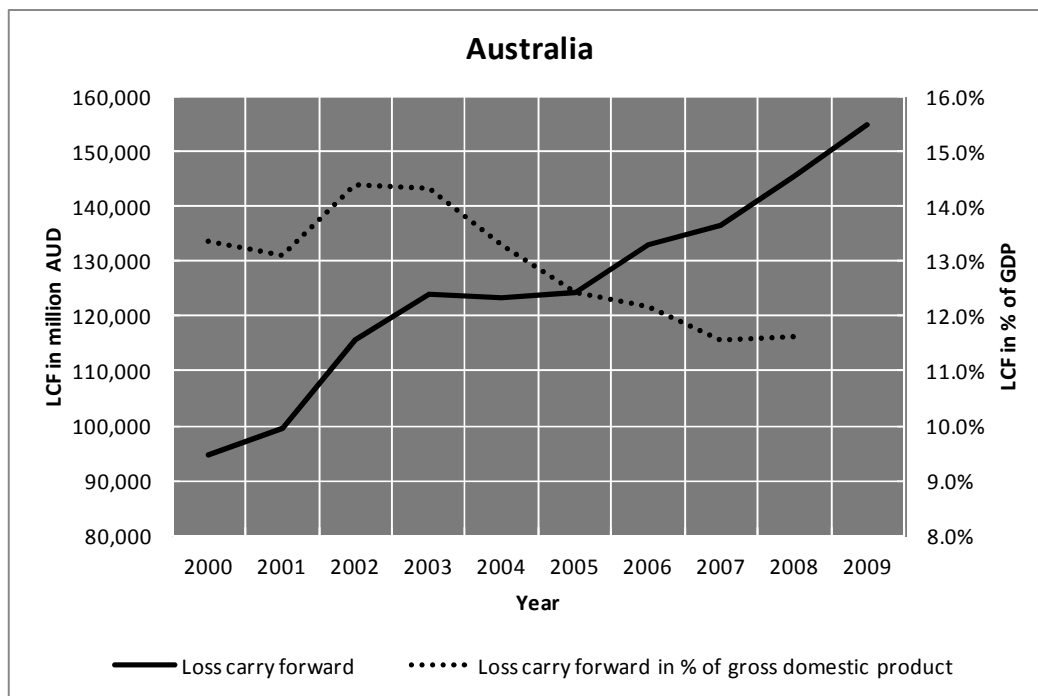
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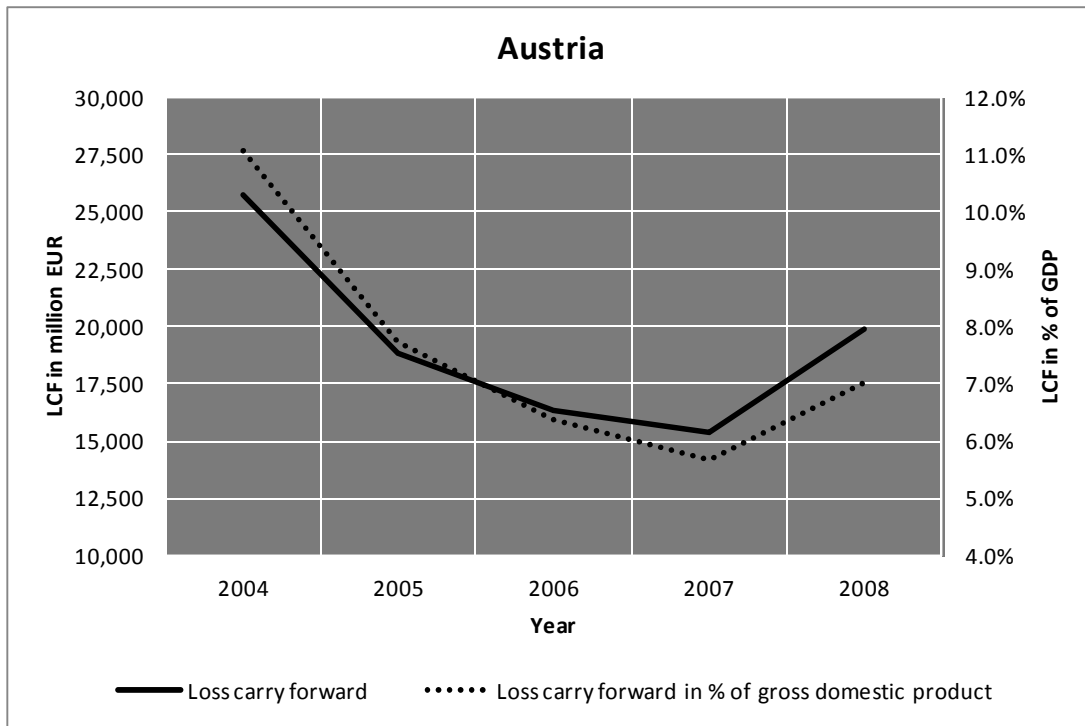
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Annex A

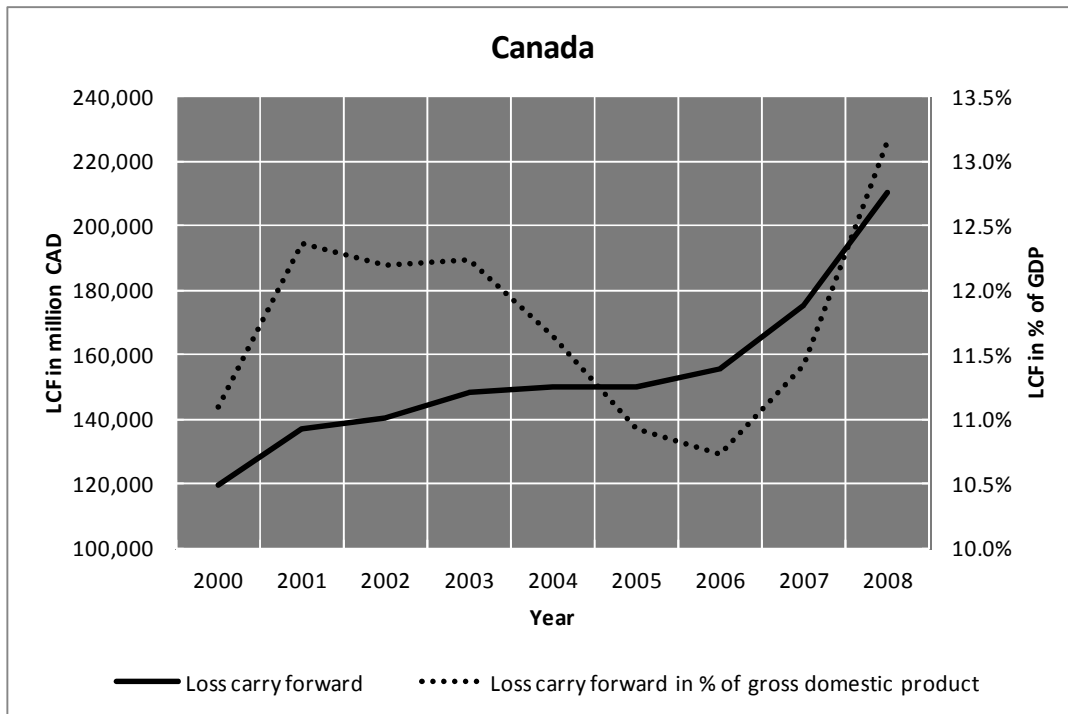
Size of loss carry-forwards compared to loss carry-forwards in percentage of gross domestic product



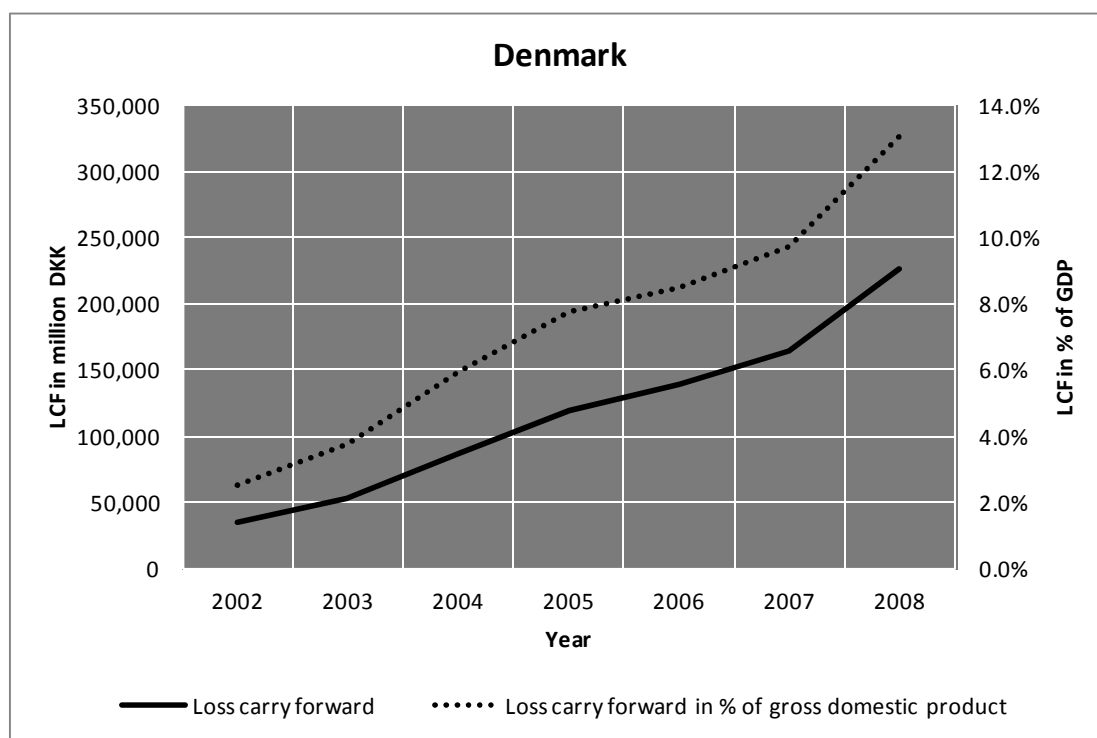
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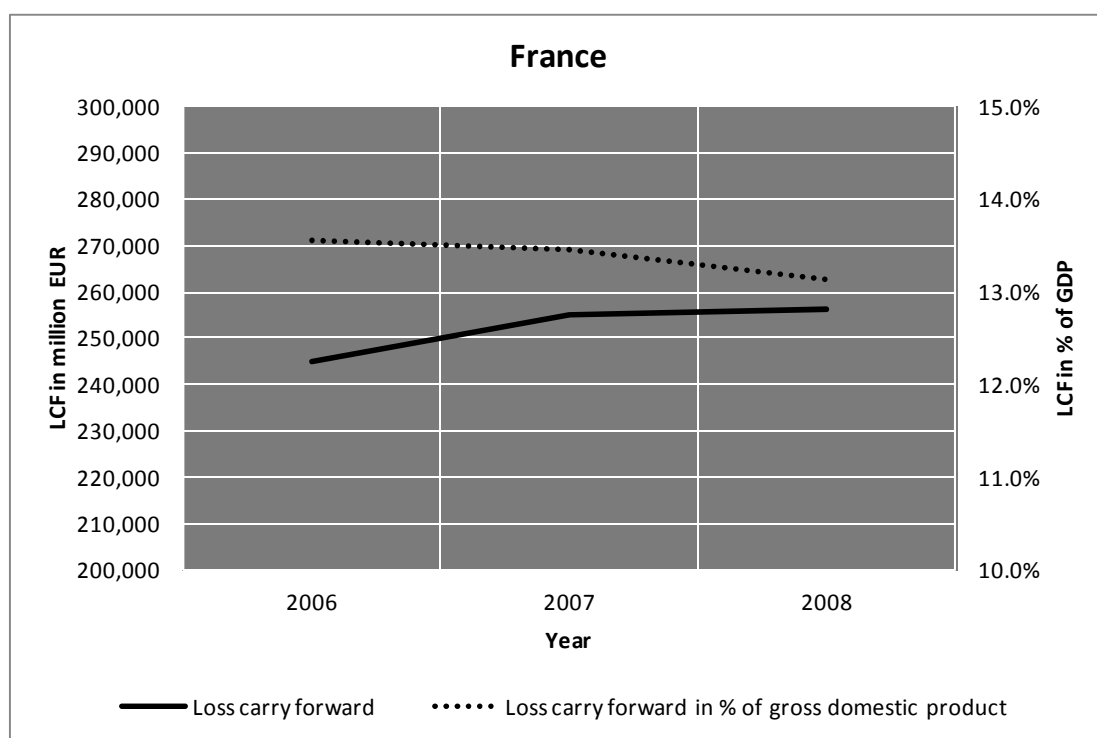
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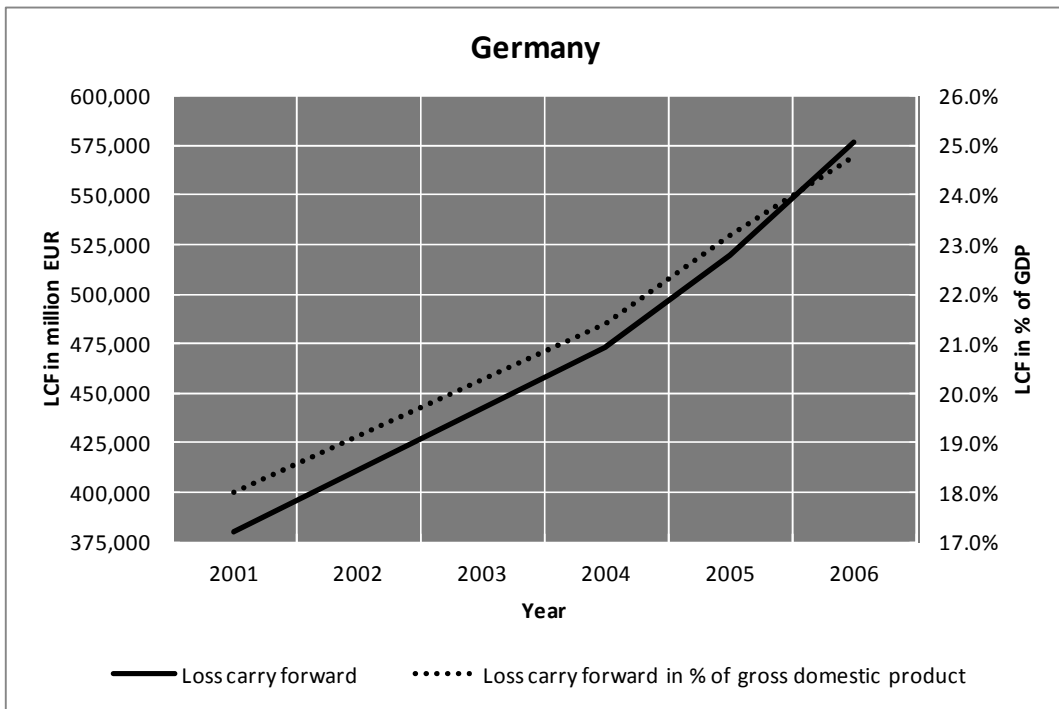
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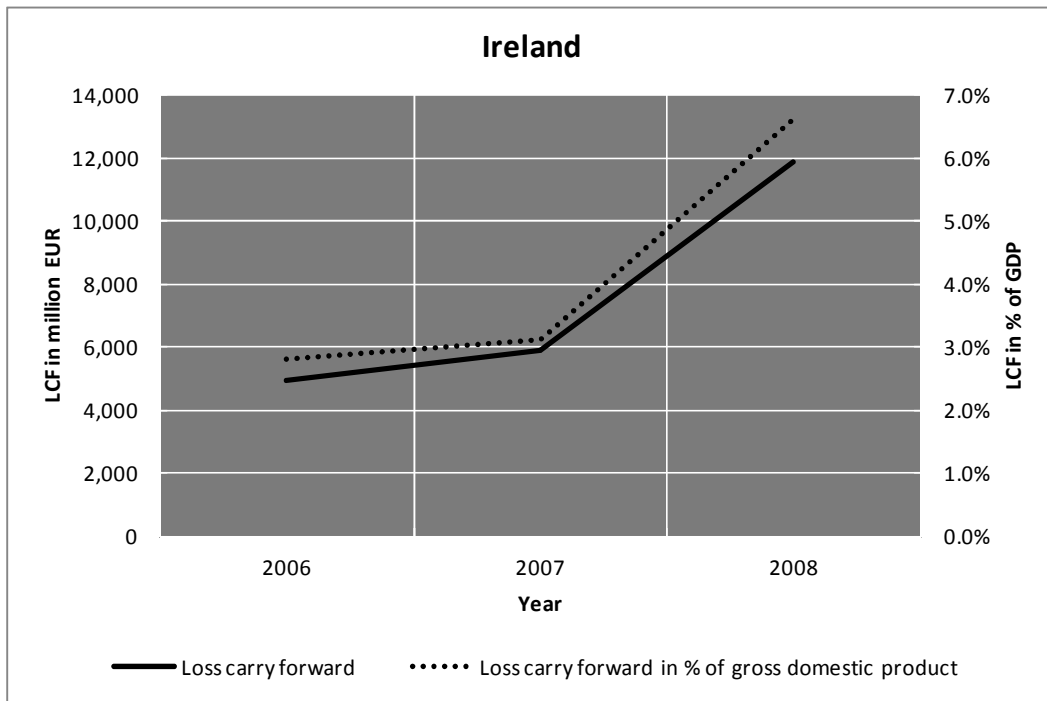
Source: Data provided by Denmark.



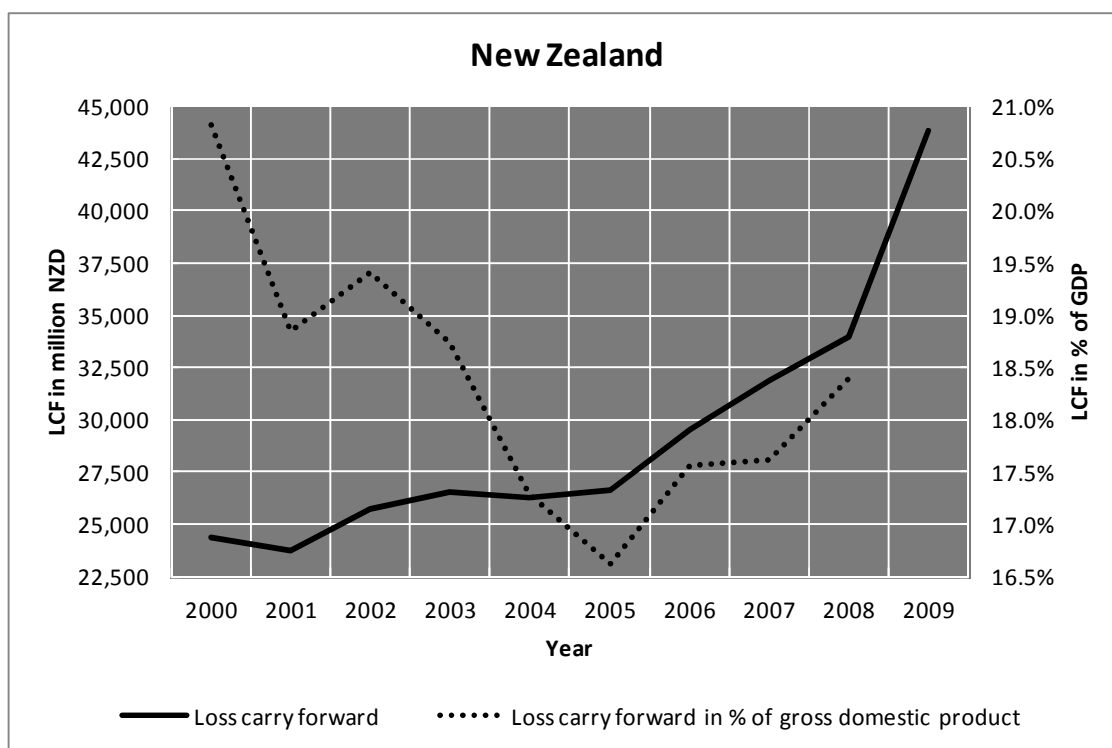
Source: Data provided by France



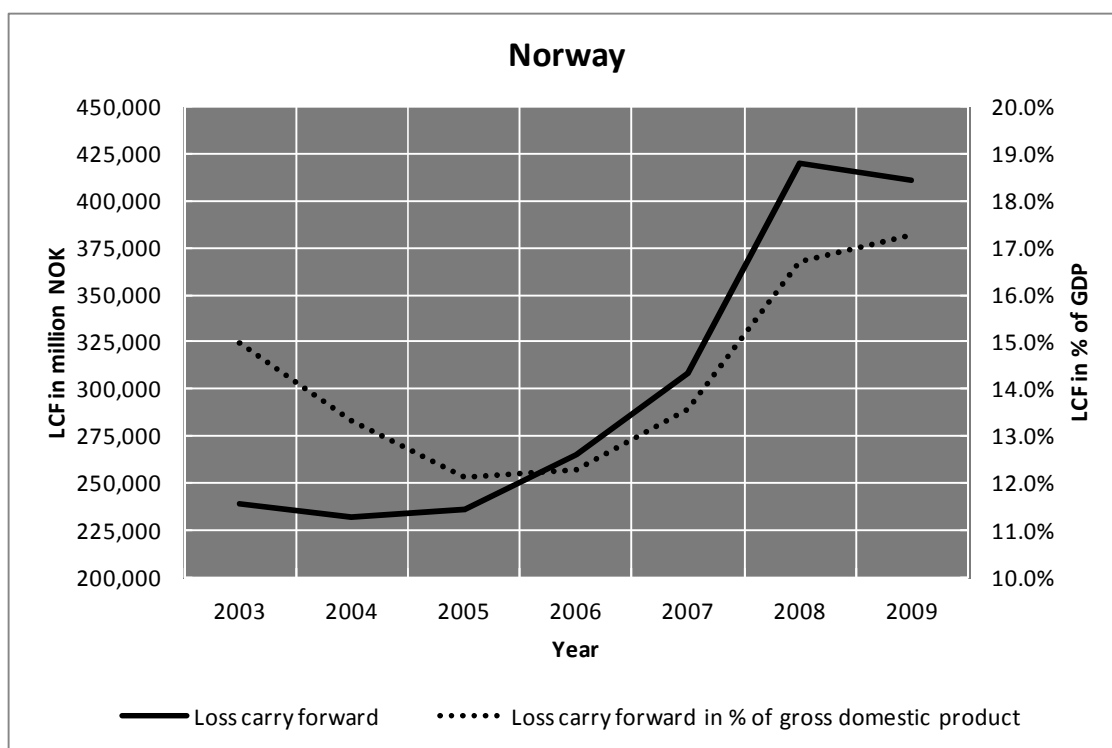
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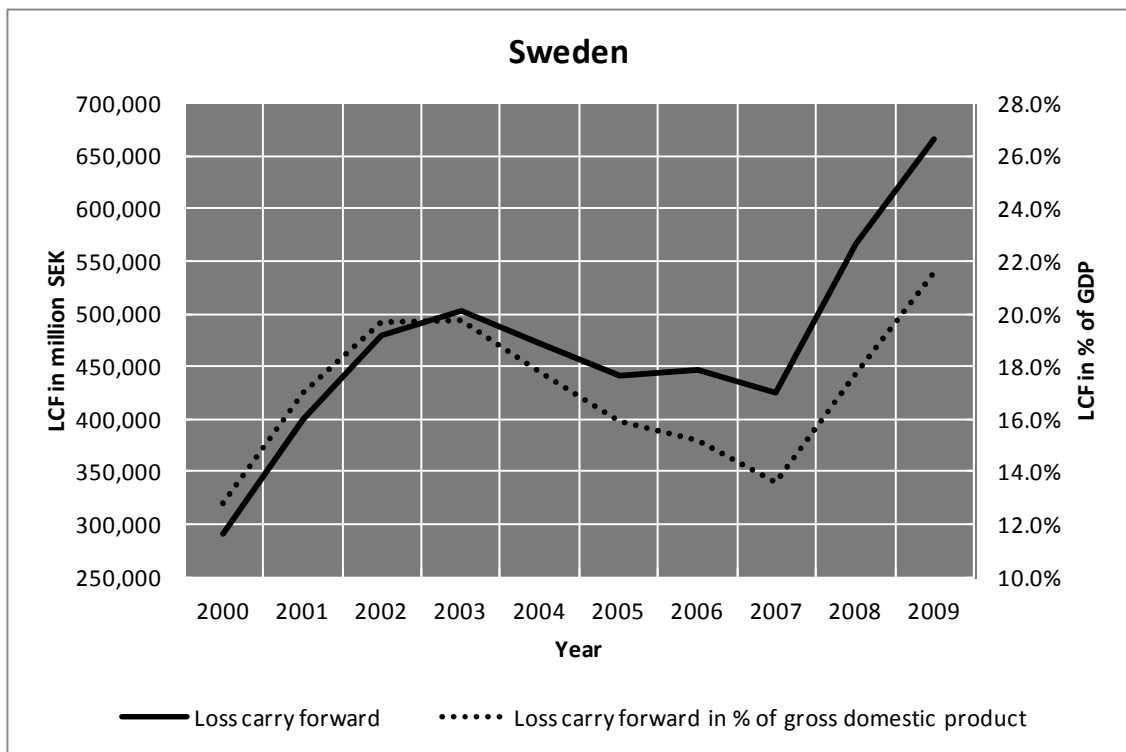
Source: Data provided by Ireland.



Source: Data provided by New Zealand.



Source: Data provided by Norway.



Source: Data provided by Sweden.

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Corporate Loss Utilisation through Aggressive Tax Planning

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Chapter 2. Policy issues in the tax treatment of losses

Chapter 3. Country rules on corporate tax losses

Chapter 4. Schemes involving tax losses

Chapter 5. Strategies for detecting schemes involving tax losses

Chapter 6. Strategies for responding to schemes involving tax losses

Further reading

Addressing Tax Risks Involving Bank Losses (2010)

Building Transparent Tax Compliance by Banks (2009)

Engaging with High Net Worth Individuals on Tax Compliance (2009)

Study into the Role of Tax Intermediaries (2008)

www.oecd.org/tax

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