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Is there such a thing as definitive losses? And if so, when? – Part 2

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Following my latest post on the Court of Justice's decision in *Commission v UK* (C-172/13, ECLI:EU:C:2015:50), I want to turn in this comment on the related issue of currency losses, which was recently addressed by Advocate General Kokott in her Opinion in case *X AB v Skatteverket* (C-686/13, ECLI:EU:C:2015:31). The Advocate General concludes that Member States are not required by EU law to provide for deductibility of currency losses occurring in connection with shares held in a foreign company: in apparent contrast to Court's ruling in *Deutsche Shell*, the denial of a deduction in such cases would constitute no restriction of the freedom of establishment and, even if it did, it would be justified by the need to preserve the coherence of the tax system. Following the Opinion's reasoning, there appears to be no escape from this conclusion. Yet it is striking that no reference at all is made to the Court's doctrine on definitive losses, which formed the (implicit) basis of the Court's decision in *Deutsche Shell*.

Which Freedom for Significant Shareholdings?

As the taxpayer in question complained about the exclusion of losses following the (deemed) sale of a significant shareholding in a company established in another EU Member State, consistent case law suggests the parallel applicability of both freedom of establishment and freedom of capital movement. While there is no difference between the two in an intra-EU situation, it is obviously quite important to come within the scope of the latter in any case concerning investments in third countries. After several years of uncertainty, the Court has recently settled on a rule to delimit the application of both freedoms (see FII GLO 3, C-35/11, para 96). As AG Kokott rightly points out, the main criterion for this is the purpose of the legislation under scrutiny: whether it is intended to apply solely to significant shareholdings or also to portfolio investments. However, despite the fact that the relevant Swedish legislation did not distinguish between participations of different size, she considers the mere fact that the taxpayer held a 45% share sufficient to result in the (exclusive) application of the freedom of establishment. AG Kokott bases this result on previous case law in which the Court decided to *also* take the facts of a case into account in determining the applicable freedom as a subsidiary rule to the legislative purpose test. It is important to note, however, that the Court has maintained the fact-based test exclusively for intra-EU situations, where the outcome of the tests is of no practical relevance. As the Court relies – since FII GLO 3 – exclusively on the purpose of the legislation to determine the applicable freedom where it matters (i.e. in third-country situations), it is difficult to make sense of maintaining this subsidiary rule, which has likely only been preserved to give the Court's case law the pretence of consistency. As a consequence, while AG Kokott's analysis is certainly in line with the Court's most recent case law on the issue,

the dearth of guidance towards a more coherent and logical unitary principle to delimiting the freedoms is regrettable.

Discrimination, Indirect Discrimination and Restrictions

As in *Deutsche Shell*, the issue whether a taxpayer's grievance can be framed as discriminatory, a restriction or an irrelevant disparity/dislocation is at the core of the *X AB* case. AG Kokott dismisses any claim to direct discrimination in one paragraph: Swedish law applies no different treatment with respect to losses – whatever their cause – from investments in domestic and foreign subsidiaries, respectively.

AG Kokott finds indirect discrimination only slightly more difficult to dismiss: she considers the possibility that currency losses might be a more common feature of investments in foreign entities, although she immediately remarks that participations in domestic companies can suffer equally from currency fluctuations due to investments of such companies in foreign currencies. She then rejects the claim of discrimination, pointing out that in any event no systematic disadvantage of foreign participations could arise, since gains from currency fluctuations would be exempt, in symmetry to the exclusion of such losses. This is a somewhat surprising basis to deny the existence of discrimination, which is normally focused on the facts of the concrete taxpayer in the case (who merely suffered losses). The argument seems more appropriate – and indeed resurfaces – in the discussion of a possible justification by reference to the "coherence" of the tax system. The second debateable claim is that participations in domestic companies can suffer "currency losses". This is only true where it is possible that shares in domestic companies are denominated in foreign currency, which is not always the case. The situation where a domestic company invests in foreign currency is different, however: in such a situation, that subsidiary might suffer a currency exchange loss, but not its parent. If – as *Deutsche Shell* might suggest – there is something special about currency losses, it is not clear that this can be transposed to losses suffered on a higher level of the corporate chain as an indirect consequence of currency fluctuations. While economically equivalent, the Court generally takes the separation of corporate entities seriously in assessing discrimination, so that it matters which entity suffers a certain loss.

The Opinion refers to the same arguments to deny the existence of a (non-discriminatory) restriction: first, it distinguishes the case at hand from *Deutsche Shell* by reference to the previous argument that a currency exchange risk also exists for domestic participations; secondly, it explains that it would in any event be necessary to assess the treatment of losses and profits together. One claim in support of this argument is especially interesting: in AG Kokott's view, if the exclusion of currency exchange losses were a prohibited restriction, then the same would have to be true in case a Member State decided to tax a currency exchange gain. That does not necessarily follow, however, just as the Court's requirement for a Member State to provide relief for foreign "definitive losses" does not imply that a Member State would be prohibited from taxing foreign profits. The argument underlying *Deutsche Shell* is that a Member State cannot allocate a currency loss arising from the closure of a PE in the situation of that case to another Member State and thus rid itself of the responsibility to take it into account, which is equivalent to saying that such loss is by its nature "definitive" regardless of the existence of operating profits in the PE state. The same could be said to apply for the equivalent loss from a foreign participation.

If it is true that the treatment of profits and losses by necessity has to be considered together to assess a tax system's restrictive effect rather than that of a singular provision, and, what is more, that this assessment is to be made at the time of a potential investment, as AG Kokott claims, then

the symmetric exclusion of any so related profits and losses would be immunised from scrutiny by the fundamental freedoms. There is certainly something to be said in favour of this view; but if does not yet appear to be the Court's position.

Justification

Concerning potential justification for any restriction – if the Court were to find such – AG Kokott clearly lays out the divergent views emerging from *Deutsche Shell* on the one hand, and *K* (C-322/11, ECLI:EU:C:2013:716) on the other: according to the Court's position in the first, system is only "coherent" if it ensures an actual advantage for the concrete taxpayer who also suffers a related actual disadvantage – taking an ex-post perspective on the investment made by such taxpayer. By contrast, in the second case, the Court considered it to be sufficient that there is a potential advantage closely linked to a potential disadvantage, namely the exemption of a (as yet unrealised) gain linked to the exclusion of a (possible) loss. In the latter case, the Court – notably deciding in a small chamber of only three judges – did not explicitly overrule the result of the former, so the issue has certainly not been settled.

AG Kokott suggests that the purpose of the freedoms would be better served by adopting the second interpretation, which would aim to protect neutrality of decision-making prior to an investment. The typical problem of definite losses arises, however, from the interaction of two tax systems, the result of which is that profits will certainly be taxed (the main question being 'where', not 'if'), whereas losses may come to be recognised in neither jurisdiction. Under these circumstances, an investor decision will be affected by the complete (and symmetric) allocation of profits and losses to another state. Admittedly, the same problem does not arise with currency profits and losses in circumstances such as those at issue in *Deutsche Shell*, since these could only arise in the home Member State, so that AG Kokott's analysis would certainly hold true for these. For losses that are not so clearly allocated by their nature to one particular Member State, as in *K*, the result is different, however.

The subsidiary-PE comparison

The obvious similarity to *Deutsche Shell* raises another question: to what extent are the situations of foreign economic activity through PEs comparable to those through subsidiaries? The Court has consistently rejected a comparison between both types of investments from the home state perspective, most clearly in *Bosal* (C-168/01, ECLI:EU:C:2003:479, para 32) and *X Holding* (C-337/08, ECLI:EU:C:2010:89, para 38). The Court explained there that Member States remain free to treat different types of business structures in different ways, as long as they do so consistently (i.e. not treating the same structure differently based on the place of their establishment). At the same time, it is clear that the Court applies the "Marks & Spencer exception" to losses suffered by subsidiaries or PEs without distinction. Whether the situation of PEs and subsidiaries can be compared thus effectively depends on the lens through which the case is being analysed.

Yet even if the doctrinal approach from *Deutsche Shell* were to be applied to the case at hand, the result would not be the same: unlike Germany in that case, Sweden did not "allocate" a loss to the foreign jurisdiction (nor did it argue for an exclusion of "foreign" costs connected to exempt "foreign" income as the Netherlands did in *Bosal*). It treats domestic and foreign shareholdings the same by exempting **all** profits and excluding **all** losses – there lies the key difference to Shell, where there was a clear different treatment between foreign PEs as compared to domestic

branches, which raised the issue of whether such could be justified by its "symmetric" nature. In *X AB*, by contrast, there is no symmetric discrimination, but actual equal treatment of domestic and foreign investments. In those circumstances, the "definitive loss" doctrine does not apply (see *Krankenheim Wannsee* (C-157/07, ECLI:EU:C:2008:588)).

The Last Word

Ultimately, one cannot but agree with the outcome of AG Kokott's analysis in *X AB v Skatteverket*, although I am inclined to diverge on a number of detailed points. The denial of a deduction for costs under the same circumstances for domestic and foreign investments does not violate any fundamental freedom – regardless of whether the Court's 'definitive losses' doctrine survived *Commission v UK*, regardless of whether the Court's interpretation of 'coherence' in *Deutsche Shell* has been overruled by its decision in *K* (C-322/11) and regardless of whether the Court was right in *X Holding* not to hold a Member State to a high standard of consistency with respect to the treatment of different (but comparable) cross-border situations. The case would of course provide yet another opportunity to the Court to clarify its position on these points, but I am not holding my breath; since they do not need to be tackled here, the Court will almost certainly leave them for another day.

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