

## ECJ hallmark ruling on the Marks & Spencer Case

December 2005

On December 13, 2005, the European Court of Justice (ECJ) finally rendered its long-awaited decision in the Marks & Spencer case. This UK resident Company owns various UK and overseas companies. It wanted to set off some tax losses incurred in other EU Member States against its UK profits. The UK tax legislation of group relief does – at present – not allow such an offset. As a result of this ECJ decision, Marks & Spencer may look forward to a reimbursement of approximately € 44 million of corporate income tax.

The court has stated that – in principle – the legislation preventing such deduction is not in contradiction with the freedom of establishment referred to in article 43 in conjunction with article 48 of the EC treaty. However, the court continued, these provisions do violate EU law if the subsidiary cannot recover the loss locally in the country of which it is a resident:

- in the year in which the loss relief in the other state is requested;
- in previous years; nor
- in subsequent years (either by the subsidiary itself, or by a third party, e.g. in case the loss recovery is denied upon the sale of the subsidiary to a third party).

As the subsidiary e.g. in Belgium was closed and the company liquidated, there were no possibilities to recover the tax loss locally. Marks & Spencer therefore claimed a deduction in the UK.

This decision may have important consequences for those tax systems in the EU, which allow tax consolidation and offset of losses only within the country. Denying cross border loss compensation may therefore not be consistent with the rules prescribed by the ECJ.

Some countries may argue that the ability to claim a loss on the liquidation of a subsidiary, including a subsidiary established in an EU Member State, is sufficient to meet the standards set by the ECJ.

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Countries which allow tax consolidation may have to review their legislation.

## Application of the ruling within the Baltic Tax Laws

Our preliminary research on the chances for Latvian, Lithuanian and Estonian companies to claim a deduction of the losses incurred by their non-resident subsidiaries under current domestic legislation, shows that currently the Latvian Law does not allow the deduction of losses under domestic Corporate Income Tax Law. The laws in effect automatically preclude the deduction by the Latvian parent of tax losses incurred by subsidiaries established in other EU Member States.

However, like the ECJ ruled with respect to the Marks & Spencer case, the deduction of losses might be subject to certain conditions, thus ensuring that they are not utilized twice, i.e.:

- the company cannot utilize its losses in the residence country due to the statute of limitation (5 years in case of Latvia);
- the non-resident subsidiary is merged with the parent company, and thus the parent can use the rights to set off the losses of the absorbed non-resident subsidiary against its current year's taxable income or the taxable income of future periods, which may not be thus used by the former.

## *Latvian Law*

According to the Latvian Corporate Income Tax Law (Article 14), if two companies merge and both the acquired company before the acquisition takes place, and the acquiring company after the merger deal are controlled by the same persons, the acquiring company may utilize the losses incurred by the acquired company or carry them forward. However, the Law explicitly allows taking into account only the tax losses, when the acquired company has calculated its taxable income according to the rules of the Latvian Corporate Income Tax Law. Thus a Latvian company is currently precluded from utilizing losses incurred by a non-resident subsidiary.

Also the provisions of the Latvian Law on the carry over of losses within a group of companies (Article 14<sup>1</sup>) allows only an offset against the taxable income of a Latvian resident company, but does not extend these rules to losses borne by EU subsidiaries.

## *Lithuania*

As Lithuania does not apply group relief (no matter whether consisting of resident or non-resident companies), the M&S ruling can not be used for tax optimization, where a Lithuanian company has a loss making subsidiary in Latvia. However, it would be possible for the Latvian parent to utilize losses incurred by its Lithuanian subsidiary, in particular, given the similarities of the income tax systems of both countries (i.e. corporate income tax rate – 15%, the term for carry forward of losses – 5 years).

## *Estonia*

A more complex case is Estonia. As this country does not have a classical income tax system (as it taxes the profit earned by the Estonian company only upon distribution to the shareholders) there are no rules on the deduction of losses and the losses have no direct significance for tax purposes. Therefore the question may arise, whether there are actually losses, which may under certain conditions be utilized by the Latvian parent company since there are no losses under Estonian tax law. Losses however do reduce the level of the dividends which can be distributed, so that the impact is indirect.

However, Estonia taxes as a deemed dividend distribution, expenses incurred by the company, but which are not recognized as business expenses. Thus one could argue that, since Estonia taxes this deemed income distribution, irrespective of its actual result (in case of a loss), it cannot "deduct" local losses. Because of its peculiar system Estonia does not know the concept of "tax consolidation", so that this court decision is not relevant for an Estonian parent. However, as the EU has disallowed this CIT system, Estonia will have to amend its tax regime at the latest by 2009. In doing so, it will have to take this case into account.

As a conclusion, we might say that the ECJ ruling may be of benefit to Baltic companies which have cross-border loss making subsidiaries, by claiming the tax losses incurred by their non-resident subsidiaries in their respective home country, should they not be utilizable in that home country.

Please note that these are merely general and preliminary findings, and tax experts must be consulted before implementation of any of the ideas expressed above. Please contact our Director of the Tax & Legal Department – Mr. Remi Troch (+3717814160; [rtroch@deloitteCE.com](mailto:rtroch@deloitteCE.com)) or our International Tax Consultant Ms. Solvita Strausa (+3717814160; [sstrausa@deloitteCE.com](mailto:sstrausa@deloitteCE.com)) if you would like to receive more information or a more comprehensive analysis of an individual case

