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Master Thesis in Tax Law

"*Measuring up*": Tax Policy Considerations on Tax Losses

A Critical Analysis of the Portuguese Corporate Income Tax Reform

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TABLE OF CONTENTS

	Page
Acknowledgements	1
1. INTRODUCTION	3
1.1. Purpose and Approach of this study	3
1.1.1. Tax losses fundamentals	5
1.2. Road-Mapping	11
2. CLOSED ECONOMY ANALYSIS	12
2.1. The year limitation	12
2.1.1. Theory	12
2.1.2. The Portuguese CIT System	17
2.1.3. Comparative Analysis	17
2.1.4. Tax policy recommendations	20
2.2. The entity limitation	21
2.2.1. Theory	21
2.2.2. The Portuguese CIT System	24
2.2.3. Comparative Analysis	26
2.2.4. Tax policy recommendations	30
2.3. The character limitation	31
2.3.1. Theory	31
2.3.2. The Portuguese CIT System	33
2.3.3. Comparative Analysis	34
2.3.4. Tax policy recommendations	34
2.4. Risk-taking and losses: a risky business?	35
2.5. Summary of conclusions: closed economy context	39
3. OPEN ECONOMY ANALYSIS	41
3.1. Theory	41
3.1.1. Cross-border use of losses	42
3.1.2. Exit taxation	49
3.2.The Portuguese CIT System	50
3.3.Summary of conclusions: open economy context	52
4. TAX POLICY RECOMMENDATIONS: WHICH LOSS LIMITATIONS FOR PORTUGAL?	52
Bibliography	55
Appendix 1	57
Appendix 2	59

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1. INTRODUCTION

In every master thesis – and this one should be no exception –, three fundamental questions must be answered. In the first place, the reason why the study is relevant (and why should someone be bothered to read it). Secondly, which methodological approach was used. Lastly, how the study is structured.

1.1. Purpose and approach of the study

Portugal has recently undergone a Corporate Income Tax reform[1]. Reforms are always necessary, but there are some guidelines that must be observed whenever reforming, in order to achieve success and, therefore, stability.

Firstly, the reform has to be well-thought, carefully designed, leaded by specialists, and supported by bureaucrats. This is necessary to achieve stability, as a reform may have significant collateral effects on the behaviour of economic actors. There is no use in reforming just for pleasure.

Secondly, the experts must have complementary backgrounds. In this case, the Corporate Income Tax is a reform in tax law. Nevertheless, since tax may have effects on the economy, an economist should better be present. Moreover, as Portugal relies partially in accounting to assess Corporate Income Tax, an accountant should also be present. Simply put, an interdisciplinary team of experts should be in charge.

Thirdly, the predictable outcome of the reform should be substantially higher than its costs. It only makes sense to reform in the following scenarios: if potential improvements can be carried out or if, after assessing the system and all its constraints on corporate behaviour, the only conclusion that can be drawn is to discard the entire system and start fresh.

Lastly, an excellent way of getting new ideas whenever reforming, especially in law, is to compare similar realities.

Therefore, it seems appropriate to do a comparative study in order to assess whether the proposals advanced by the Reform Commission in the field of tax losses are in line with the global trends.

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[1] The reform was operated by Decree-Law number 2/2014, of January 16th.

In face of this, how exactly do we propose to approach our subject of research?

This study uses two main tools: comparative tax law and an interdisciplinary approach.

Comparative tax law is useful in order to assess the possibilities and experiences of similar countries. In fact, it is useful to understand its underlying tax policies. Tax policies are important, as the tax laws change very often, and the underlying policies normally stay the same.

Furthermore, *"examining comparative policy choices is necessary not only to reveal the weaknesses of any local tax system but also to understand its areas of strength"*[2].

In this study, we compare the experiences in Portugal, the European Union and the United States.

Why? Portugal is a Member-State of the European Union ("EU"). As Portugal is part of the EU, there was no use in simply defining which would be the best treatment regarding tax losses at a purely domestic level. Therefore, a small incursion in EU law regarding the treatment of cross-border losses was carried out.

References are made throughout to the, still not approved, Common Consolidated Corporate Tax Base Directive ("CCCTB"). According to Gambarino, through a study of CCCTB, "*we can reveal the existence of an EU common model of tax consolidation on which the agreement can be reached through reinforced cooperation"*[3]. It is useful to see what would be the tax losses treatment within the EU, were it to be approved as it currently stands[4].

United States' literature was extensively dealt with for one very straightforward reason: its notorious advance over other jurisdictions in the discussions on the treatment of tax losses.

Nevertheless, in certain points, such as year loss limitations, other jurisdictions were studied. This was the case of the United Kingdom. This is due to its unique approach on this subject, which consists in allowing for unlimited carryforward of losses only for

[2] See REUVEN AVI-YONAH, *Global perspectives on Income Taxation Law* (Oxford), p. xix.

[3] See CARLO GAMBARINO, *An Evolutionary and Structural Approach to Comparative Taxation: Methods and Agenda for Research,* p. 709 (2009).

[4] Note that the CCCTB is currently under discussion at EU level by a group of experts. The proposal was not withdrawn.

business income. The German system was also used in order to have a Civil Law comparative. Finally, in very limited cases, we will make reference to Australian tax law.

One must never forget that taxation, despite being regulated in tax law, is a transversal phenomenon in social sciences[5]. It has implications in economics, political science, history and sociology and thus, an interdisciplinary approach is useful, if not even necessary.

This interdisciplinary approach consists, in this study, in tax policy considerations, with particular focus on political economy and public finance. Nevertheless, literatures in other ancillary subjects were taken into consideration, such as behavioural economics, corporate law, accounting and business management.

1.1.1. Tax losses fundamentals

The purpose of this section is two-fold: first, to serve as an introduction to this thesis and, second, to explain some basic concepts regarding tax losses, which will be used throughout the following sections.

Every Corporate Income Tax ("CIT") system in the world differs from the others. Nevertheless, there are three basic pillars which are shared by all CIT systems[6]. The mentioned pillars are: a corporate-level tax, the use of a realisation-based taxation and the yearly tax-assessment rule.

A corporate-level tax means that, as a general rule, only corporations *per se* are taxed in a CIT system. Corporations *per se* may be contrasted with pass-through entities, like partnerships, which are generally taxed at the Personal Income Tax ("PIT") level.

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[5] See AJAY MEHROTRA, *The New Fiscal Sociology: Taxation in Comparative and Historical Perspective*, p. 1 ("Political scientists know that tax cuts are a major partisan battleground (…). Legal scholars know that the tax code has become the preferred vehicle for promoting an enormous variety of domestic policies – from social provisions to industrial policies to educational subsidies. Historians know that taxation has been a pivotal source of conflict and change (…) and that taxes have been central to the formation of civic identity across time and place. Sociologists know that nearly every issue with which they are concerned – the obligations of the individual to society; the powers and legitimacy of the state; the allocation of public and private resources; the rise of bureaucratic administration; the reproduction of class, race, and gender inequalities – runs through the issue of taxation.").

[6] For a more detailed analysis, see MIGUEL CORREIA, *Taxation of Corporate Groups* (2013), p. 84 *et seq.*

Corporations are, in some sense, almost like natural persons, as they can own property, pursue legal action and enter into contracts in their own name. In fact, they can be perceived as – and are – separate legal persons other than their shareholders. However, not all corporate-like entities are taxed at CIT level. In order to be taxed at the CIT level, it is imperative that, besides meeting a legal criterion (i.e., being a separate legal entity), an economic criterion is also met. This economic criterion is the separation between ownership and control.

In fact, there are some corporate entities that are not taxed at the CIT level, as they have not fulfilled one or even both criteria. Thus, these entities are taxed at the PIT level. That is the case, in several countries, of, for instance, closely-held corporations or professional associations.

The US has a peculiar approach to this issue. In order to deal more efficiently with the manipulation of entity classification rules, the Check-the-Box System was created. According to this system, in Form 8832, domestic and foreign corporation-like entities other than corporations *per se*, can choose to be taxed under CIT rules. Thus, Limited Liability Companies ("LLC"), Limited Liability Partnerships "(LLP") and Partnerships can choose to be taxed at CIT level. In general, this choice lasts for a period of five years.

Let us now look into the second pillar, that is, realization-based taxation. The realisation rule derives from a tax policy consideration that, from all stages of wealth – creation, holding, transfer and consumption –, the easiest one to levy taxation on is the transfer. Therefore, taxation should be triggered only when a qualifying transfer occurs.

In general, a qualifying transfer occurs when the following conditions are met: value must be bestowed, property exchanged must be substantially different and there must be distinctive legal entitlements. Note that the qualifying transfer cannot be exempted under non-recognition provisions, as occurs under certain tax-free reorganisations.

An example might help understanding when a qualifying transfer occurs.

Corporation A sells a machine that was used in its production process to Corporation B. Consideration was $ 1,000. Value was bestowed, as the machine was sold. Property exchanged was substantially different, as Corporation B gave cash and Corporation A

gave a machine. There were different legal entitlements, as Corporation A was the seller and Corporation B was the buyer.

Realisation is a hybrid rule, since it taxes the creation of wealth, i.e., the purchase of the machine by Corporation A, when it was transferred to Corporation B.

Note, however, that are events treated as deemed realisation. Simply put, this means that the event is taxable, i.e., that a qualifying transfer occurred, even though no consideration whatsoever was given. That is the case, for instance, of the exit of a corporate group member of a consolidated group under the tax laws of several jurisdictions.

A qualifying transfer leads to taxation. Nevertheless, the moment of allocation of all inclusions and deductions due to taxable events is effectively taken into account for tax purposes depending on the methods of tax accounting, i. e., depending on whether the cash, the accrual, or a hybrid method, is adopted.

Under the cash method, income and deductions are registered only when the income is effectively disbursed. This method is often used by taxpayers that are not obliged to keep financial books and records.

Under the accrual method, on the other hand, the income and deductions must be registered whenever the transaction occurred, irrespectively of when actually received or paid out. This method is normally used by taxpayers that maintain financial records and books.

Lastly, the third pillar. The yearly-tax assessment rule states that, as a norm, CIT is calculated and paid on a yearly basis.

There are practical reasons that justify this rule. Firstly, it allows the Government to receive income on a periodic basis, i.e., once a year. Secondly, it is much simpler, from an administrative perspective, to assess and liquidate tax once a year than every month.

These three core pillars can still be divided into six secondary pillars[7], which give operational content to these core principles. These secondary pillars are: the divide between business and capital income, the rules to define and treat distributions, the dual

[7] For a more detailed analysis, see *ibidem,* p. 88 *et seq.*

set of tax attributes, the continuity of interest principle, the capitalization, depreciation and amortization rules and, finally, the limitations on the use of losses.

In general, the divide between business and capital income classifies income according to whether it generated, or not, from a regular business activity. Should the income derive from the normal activity of the corporation, it is classified as business or ordinary income. Should the income derive from the extraordinary activity of the corporation (e.g., by selling its current assets in order to organise the means of production more efficiently), it is classified as capital income. This distinction is relevant as the realisation principle gives the taxpayer selectivity in the timing of recognition of income, most especially, capital income. Thus, the sale of capital assets may be selectively triggered in order to reduce business income and, therefore, reduce taxable income.

The rules to define and treat distributions (of dividends) serve to mitigate double taxation. This can be done by changing any part of the fundamental tax equation either at the corporation or the at shareholder's level. For instance, at shareholder level, we can exclude the dividend from the taxable base, lower the applicable tax rate or give a credit for taxes paid at corporate level.

The dual set of corporate tax attributes exists as shareholder's dispositions of stock need to be taxed independently of corporate-level events. As such, a distinction is needed. Outside basis refers to the stock and allows keeping track of untaxed amounts. Inside basis refers to the tax value of assets and allows us to keep track not only of the untaxed amounts but also of the depreciation and amortization history of the assets. This distinction is also relevant in the design of corporate acquisitions, as one can buy the shares (share deal) or, instead, buy the underlying assets to the corporation (asset deal), often with differing tax consequences.

The continuity of interest principle has the purpose not only of improving market efficiency but also of avoiding manipulation of the realisation rule and the abuse that can derive from it. Thus, if there is a substantial continuity of interest as defined by law, the transaction will not be recognized and, as such, taxation will not occur.

The capitalization, depreciation and amortization rules serve to implement the realisation principle and the yearly-tax assessment rule in the real world of transaction

costs and information asymmetries. Under these rules, the tax value of assets can rise (capitalization) or lower (depreciation, in the case of tangible assets, and amortization, in the case of intangible assets).

The loss limitation pillar will be developed throughout this paper, thus not even a brief explanation will be carried out at this moment.

Despite the importance for our study of understanding this basic systemic framework, an extensive study of all these secondary pillars clearly falls outside the scope of this thesis. Thus, only the loss limitations secondary pillar will be fully developed, notwithstanding the other pillars being given a more detailed explanation throughout this study whenever necessary.

Before entering into more detailed considerations about the treatment of tax losses, it would be useful to better define the concept. In general, a tax loss occurs when a corporation has more expenses than profits. Note, however, that both the expenses and the profits must be relevant for tax purposes [8]. Therefore, when assessing the corporation's taxable income, the outcome must be a negative number. That being the case, multiplying a negative taxable income by the tax rate, will result in no tax having to be paid.

Simply put, and using a simplified version of the fundamental tax equation,

Negative taxable income, i.e., a tax loss x tax rate = no tax to be paid

Now, one might wonder what happens to this tax loss. The answer is: it depends on the CIT system. Specifically, it depends on the CIT rules regarding the limitations on the use of losses.

There are three types of limitations on the use of losses: character, entity and year.

The character limitation derives from a distinction that can be made when it comes to income generated by a business. All income can be treated in the same manner, no formal distinction being made between business income and capital gains. This system is quite common in continental Europe. However, in order to avoid cherry-picking, i.e.,

[8] There are three models regarding dependency on accounting: total separation (used, to some extent, in the United States), total dependency and partial dependency (used in Portugal).

the selective triggering of losses in order to reduce taxable income, restrictions may apply. This introduces a schedular element into the system, as noted by Avi-Yonah[9].

Common law countries are, generally, schedular systems in this regard, as they tend to apply a formal distinction between business income and capital assets. Accordingly, there is a need to classify assets as capital assets or not. Note that this divide is often made by exception and, thus, all items not excluded as capital assets are treated as capital assets.

Where this divide is into force, either formally or practically, prior losses can only be offset against the same type of income. The main justification for this divide is to prevent the manipulation of the realisation rule resulting in lowering as much as possible the taxable income.

This divide can also be justified economically. The economic distinction refers to the predictability of proceeds deriving from that asset. That is, if the proceeds can be expected, since they derive from the purchase of the asset and its normal utilisation, they should be considered as business income. In turn, unexpected gains, such as those resulting from the sale of the asset, do not constitute the core of the business and, therefore, must be considered capital gains, as they result from *ex ante* anticipations in flows of income.

The entity limitation serves to avoid the transferability of losses between entities. The main policy justifications are to avoid loss trafficking and to generate efficiency in the economy.

The year limitation intends to counteract the negative effects of the yearly tax-assessment rule, namely, prioritising the regularity of income revenue and not taking into consideration the economic cycles. There are two mechanisms to fulfill this purpose: the carryforward and the carryback of losses.

The carryforward of losses mechanism allows the corporate taxpayer to offset its prior year losses, within a given period of time, against the positive taxable income in the following years. Note, however, that the character limitations generally remain applicable whilst using this mechanism.

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[9] See REUVEN AVI-YONAH, *ob. cit.,* p. 59.

In turn, the carryback of losses mechanism allows the corporate taxpayer to offset its current year loss against its positive taxable income of previous years, within a given period of time, and to receive a refund from the Tax Authority ("TA"), by retroactively reducing its taxable income. Note, however, like above, that the character limitations remain applicable whilst using this mechanism.

It is worth to mention, even if very briefly, the role of loss ownership, as it will determine to whom the refund will be made. According to Donnelly/Young[10], "*if the loss is considered to belong to the corporation, it should not be transferrable to other corporations or individuals. (...) If, instead, the loss is considered to belong to the shareholders or the corporate group of which the company is part, there should be some provision for the loss to be transferred from the loss corporation to another taxpayer within the group or to its shareholders.*"

According to the record in the individual tax attributes of a corporation, losses can be classified into Net Operating Losses (hereinafter, "NOLs"), Net Capital Losses (hereinafter, "NCLs") or Built-in Losses (hereinafter, "BILs") [11].

NOLs are business income losses, which are net since they result from the inclusion and deduction of, respectively, the business income profits and the business income expenses.

NCLs are exactly the same thing as NOLs, but they refer to capital income.

BILs arise whenever the tax value of an asset is higher than its fair market value. However, the loss is built-in since it did not occur a transfer yet, triggering taxation, according to the realisation rule. Note that only assets can generate built-in losses (or gains, whenever there is appreciation, i. e., whenever the tax value of the asset is lower than its fair market value). Indeed, the tax value of cash should always match its fair market value.

1.2. The structure of the study (road-mapping)

This study is divided into 4 chapters. Chapter 1, which you are reading right now, serves as an introduction to the thesis.

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[10] See MAUREEN DONNELLY/ ALLISTER YOUNG, *Tax losses: How does Canada compare,* p. 437.
[11] See MIGUEL CORREIA, *ob. cit.,* p. 97.

In chapter 2, we start with a closed economy analysis, assuming that there are only domestic transactions and entities involved in the context of each tax loss limitations – year, entity and character. First, a theoretical explanation of the analysed limitation is provided. Then, the relevant tax systems are analysed regarding that particular limitation. All this explanation is intertwined with the study of the impact of taxation, namely on the treatment of tax losses, on corporate risk-taking and on entrepreneurship.

In chapter 3, the analysis is carried out in terms of open economy, i. e., assuming that countries interact with one another and that they are not alone when trading. This analysis is only carried out at the European level. It is very much based in the European Court of Justice's decisions on the treatment of cross-border losses and exit taxation.

Lastly, in chapter 4, tax policy considerations are provided and, in the light of the previously concluded best tax policy practices, the outcome of the Portuguese CIT reform is analysed.

2. CLOSED ECONOMY ANALYSIS

In this section, we analyze the treatment given to tax losses, assuming that all business transactions are carried out domestically. Under this framework, we will analyse all limitations on tax losses – year, entity and character limitations – and how these rules have an impact on corporate risk-taking and entrepreneurship.

2.1.THE YEAR LIMITATION

2.1.1. Theory

According to the yearly tax-assessment rule, for administrative purposes, there is a legal fiction that each corporation is liquidated at the end of the year[12] and created once again at the beginning of the following year. The objective of this rule is to (i) facilitate the preparation of the required information by the taxpayer; (ii) the collection of revenue by the TA and; not less important, (iii) to ensure a periodic source of revenue to the Government. In order to counteract the negative effects of the yearly tax-assessment rule, losses must be carried over, i.e., must be used to reduce the taxable income of

[12] As a rule, the tax year may follow one of these two criteria, depending on the need to keep financial books: the calendar year (when it is not necessary to keep books) and the financial year (when books must be kept).

other tax years. Previous year losses may be used to reduce the taxable income of the current year, but also of the following years – the carryforward mechanism – or the current year loss may be used to retroactively reduce the positive taxable income of previous years and generate a refund – the carryback mechanism.

Those mechanisms are based on the idea of income averaging. The same is to say that the main goal of these mechanisms is to avoid penalising corporations without a stable income. Corporations, regardless of the stability of their income, must be given the same treatment by tax law. This is, in fact, the application of the neutrality principle, as income averaging is the only way to avoid market distortions.

Both mechanisms have their pros and cons. However, we will try to prove that they must not be seen as antagonistic but, in fact, as complementary.

Carryforward is generally easier to administer, since it does not involve a reopening of a prior tax return. Also, it has a smaller impact in the State's budget, since it is not necessary to give refunds.

Discussion arises whether carryforward should or not be limited.

Unlimited carryforward is generally defended based on the principle of net taxation. According to this principle, taxation can only arise whenever *all* previous losses have been deducted to the positive taxable income. Another argument is that it is more beneficial for start-up businesses, as normally, in the short term, they only have losses[13]. The last argument is that the taxpayer is already penalised by the loss of interest. Michelsen[14] even makes a concession in order to defend the importance of unlimited carryforward, stating that "*at the limit, if budgetary concerns surface, a legislator may consider introducing some kind of minimum taxation which limits the amount of the loss offset in any given subsequent period to a certain percentage of the profits of that period or to certain fixed amounts.*"

The main argument put forward to the limitation of the carryforward is the principle of prescription. According to this general principle of law, some rights are not life-long,

[13] Due to the need to offset investment, profitability takes longer when starting up a business.
[14] See AAGE MICHELSEN, *General Report*, *in* Tax Treatment of Corporate Losses (1998), p. 27.

but have instead a time limitation to be used or they will expire. If not used during the period given, the right of offsetting losses expires.

Other arguments for the limitation can be aggregated into a practical category, and can be summarized as follows:

Firstly, unprofitable companies are not able to survive forever and, therefore, it is not necessary to provide unlimited carryforward, as it will only be a matter of time when liquidation will occur, not if they will be liquidated, as that is a fact.

Secondly, the difficulty in storing information for a long period of time, allied to the need to prevent abuse, justifies the limitation of carryforward. One must bear in mind that one of the reasons why corporations are taxed is the easiness to administer such tax, as there are less corporate taxpayers than individual taxpayers. This justification would be senseless if the many practical difficulties were into force, due to the application of unlimited carryforward. Nevertheless, it is difficult to accept that storing information to assess tax benefits would imply an unbearable administrative burden to the taxpayers.

Last but not the least, budgetary considerations must be taken into account, as it is not easy to foresee the impact of unlimited carryforward in the State's budget.

Note, however, that carryforward may also be capped in the same manner presented below for carryback.

Carryback, in contrast, involves the reopening of a prior tax return, thus being more difficult to administer and has a bigger impact in the State's budget, as it results in a refund.

On the downside, economic theory shows that the carryback system favours old-established businesses over new ones[15].

Despite seeming that it only has disadvantages, carryback shouldn't be excluded without careful consideration. According to the OECD, the carryback might be useful for companies with difficulties that cannot carryforward their losses in the short-term, as

[15] See DOMAR/MUSGRAVE, *Proportional Income Taxation and Risk-taking*, p. 392.

well when the company intends to cease activity in the present year. Note that carryback may contribute to stabilising the economy[16].

Also, as noted by Miguel Correia[17], "*the loss that may be carried back may be capped: (i) to the amount of taxes that the taxpayer paid in the preceding years to which the carryback is allowed and/or (ii) to a fixed monetary limit (e.g., EUR 1 million); and/or (iii) to a variable monetary limit that differs based on an indicator that takes into consideration the size of the company at stake (…)*".

Another reason generally advanced for limiting the carryback mechanism is the principle of prescription, as noted by the OECD.

Despite being the most widely accepted system of loss relief, from an economic perspective, the carryover of losses is not the only alternative.

The other alternative is a recoupment or refund system. According to this system, taxpayers are entitled to fully receive the tax value of a NOL[18], in a form of refund granted by the Treasury in the same year the loss is sustained.

Proponents argue that the refund system has countless advantages, such as treating similarly situated taxpayers equally, lessening the allocational distortion of tax-induced investment decisions, reducing administrative complexity and eliminating the double taxation on capital[19]. Moreover, other positive effects can derive from the refund system, according to its proponents. Firstly, as the value of a loss as carryforward is always less than its value as a carryback, recoupment mitigates the consequences of inflation, whilst providing a refund in the year in which the loss is sustained. Secondly, it prevents tax-driven mergers as well loss-trafficking, which are needed for the loss corporation to use the losses sustained.

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[16] See OECD Report "*Corporate Loss Utilization trough Aggressive Tax Planning*", p. 37. According to this report, various countries introduced temporary carryback rules due to the financial crisis.

[17] See MIGUEL CORREIA, o*b. cit* , p. 255.

[18] According to MARK CAMPISANO /ROBERTA ROMANO, *Recouping Losses: The case for full loss offsets*, the value of the tax refund may be summarized as follows:

Cash value of the loss x Tax rate applicable to that amount of income = Value of tax refund

[19] *Ibidem,* p. 715 *et seq.*

Opponents put forward the following arguments against recoupment[20]: it encourages inefficiency, subsidises businesses with a negative income tax and it helps to contrive artificial losses.

It encourages inefficiency in the sense that insolvency may be delayed, by receiving refunds. However, proponents argue that inefficient businesses are bound to fail in an imperfect economy.

It subsidises businesses by giving them immediate refunds for their losses, and this might jeopardise competition, as some businesses do not receive subsidies of any kind. Proponents argue that this is simply a means of achieving equity among taxpayers and investment neutrality. Further, proponents argue that a refund is not a subsidy, as it does not vary according to the particular characteristics of its recipients.

This dependency on the refund might generate an addiction. In fact, a corporation may start not carrying out business activities at all, just contriving artificial losses, financing itself with the refund given. Proponents argue that this already happens.

Despite being often argued that recoupment would not increase costs, this is not true. According to Donnelley /Young[21], "*it is said that it would have no impact in Government revenues. Statistics show, however, that it would always have an impact in revenues.*". The reason why is quite straightforward. Although proponents argue that moving from a partial refundability system to a full refundability system is only a matter of speeding up loss utilization, the truth is that normally losses are not fully used, as they expire over a certain period of time. Therefore, the State would be losing money if this regime would be adopted. In addition to this, Canada's Department of Finance has expressly dealt with this issue and has state that "*The full and immediate refundability of losses would substantially reduce or virtually eliminate corporate income tax revenues for several years. With reduced taxes on business, governments would need to increase business taxes by other means.*"[22]

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[20] *Ibidem*, for an excellent sum of arguments against recoupment, as well their counter-arguments.
[21] See DONNELLY/YOUNG, *ob. cit.,* p.445.
[22] See *Report of the Technical Committee on Business Taxation*, p. 4:15. Moreover, according to MIGUEL CORREIA, *ob. cit*., p. 248, there were other reasons mentioned in this report rejecting this policy, such as (1) to reduce the availability of tax incentives to inefficient businesses that are more likely to earn a low economic rate of their of return on their investments compared to efficient businesses; (2) to reduce the scope of tax evasion that arises when the businesses report claims for refund are made; (3) to

So, despite having advantages, these advantages are not enough to enable a tax reform in this direction, as it only makes sense to change the system when it leads to a higher degree of efficiency.

Therefore, the refund system has never been implemented and, thus, the only system of loss relief into force is the carryover of losses.

2.1.2. The Portuguese CIT system

Under the Portuguese CIT system, carryback is not possible. In fact, such mechanism is not even present in the Portuguese Corporate Income Code ("CIRC").

It must be noted, however, that although a formal carryback mechanism is absent from Portuguese legislation, there are mechanisms that aim at partially minimising such absence.

Take the article 79 (4) of CIRC as an example. In such provision, tax losses resulting from a liquidation of a corporation are dealt with. In general, a liquidation is a process consisting of a sale of all the corporations' assets in order to distribute them among the shareholders. The CIRC considers all the liquidation period of a maximum of two years as one sole period. This results in allowing the carryforward of losses for that extra period, as carryback is not possible.

The carryforward of tax losses is possible, according to article 52 (1) and (2) of CIRC. However, it is limited to up to twelve years[23] and is capped to 70% of the taxable income.

These restrictions are applicable to either single companies or corporate groups.

2.1.3. Comparative Analysis

Under the **US CIT system**, both carryforward and carryback of losses is allowed. However, both are limited in time, although with differing time limits. As the US CIT

preserve the business tax base and to preserve a substantial revenue loss to governments and (4) to reduce the volatility of corporate income tax revenues and resulting spill-over effects into other parts of the tax system.

[23] The Portuguese legislation on the carryforward of tax losses has evolved as follows: from 1988 up to 1997, the carryforward period was 5 years; from 1998 up to 2001, it was 6 years; from 2002 up to 2010, it was 4 years; from 2011 up to 2013, it was 5 years, being the usable amount of losses not more than 75% of the taxable income.

system has implemented a formal divide between the two types of income, each type of income has its own carryback and carryforward period.

The Internal Revenue Code ("IRC") section 172 regulates the year limitation applicable to business operating losses. It allows losses to be carried back for two years and to be carried forward for twenty years. Note that, despite not being unlimited, it is still a very generous window frame to carryforward business losses, as predictability of revenue comes into consideration.

Capital losses are regulated under IRC Section 1212. The mentioned IRC section allows a carryback period of three years and a carryforward period of five years. Compared to the window frame for the business losses carryforward, the five year period may seem too short. Note that anti abuse considerations come to play when defining tax policy and that the potential abuse of selectively triggering capital losses must be taken into consideration; thus, this limit seems reasonable.

It is important to stress that these window frames apply to group taxation as well.

Moreover, regarding both types of income, although an election regime is also available, as a rule, one should try to carryback the loss first and, only if not possible, should the loss be subject to carryforward. This is due to the concept of time value of money. The value of the money changes over time because of inflation and, therefore, should be used as soon as possible. Another factor that contributes to this is the existence of progressive tax rates in the IRC.

Under the **UK CIT system**, a formal divide between business and capital income is also implemented. Please bear in mind that, despite the UK legislation referring only to capital and trading losses, the concepts of British trading losses and American business operating losses are similar. For the purpose of this study, and for the sake of coherence, trading losses will be referred throughout this section as business losses.

As the UK Corporation Tax Act does not have any provision limiting carryforward for both business and capital income, it is safe to assume that carryforward is always unlimited. This is the principle of net taxation applicable to its full extent. Regarding economic policy, there is no better way to tax.

Carryback, on the other hand, is not possible in capital losses. Therefore, only business losses can be carried back.

Normally, the carryback window frame for business losses is one year. Notwithstanding, there is a special period of three years that is applicable only whenever a company ceases trading or when its trading losses refer to the accounting periods between 24 November 2008 and 23 November 2010[24].

The **German CIT system** has a quite interesting rule concerning the carryover of losses. As it is a global system, no (formal) character distinction is made.

Not only does Germany allow both the carryback and carryforward of losses, but caps them both.

In fact, the carryback is capped at €511,500. This turns the carryback less attractive to larger corporations.

On the other hand, the carryforward of losses is also capped, as a result of a minimum tax measure that was implemented in order to restrict the rate at which carried forward losses may be used. Therefore, losses can only be deducted at a maximum of € 1 million. Should the corporation wish to reduce even more its taxable income, it is limited to €1 million plus 60% of the amount of losses exceeding the €1 million barrier. The unused losses may still be carried forward indefinitely, though respecting the capped ceilings laid out in tax law.

Article 43 of the **CCCTB** allows unlimited carryforward, but disallows carryback. In sum, there was an European consensus on the need to apply the principle of net taxation to its full extent – applying an unlimited carryforward - and to simplify the system as much as possible – disallowing carryback -, in order to create a system very easy to administer at an European scale. Besides, the CCTB proposal itself, in recital 15, states that *"taxpayers should be allowed to carry losses forward indefinitely, but no loss carry back should be allowed. Since carry forward of losses is intended to ensure that a taxpayer pays tax on its real income, there is no reason to place a time limit on carry*

[24] As noted by OECD in its report, *ob. cit,* p. 37, some countries enacted special carryback provisions in order to stabilize economy. It is not by accident that this period coincides with the peak of the financial crisis!

carry forward. Loss carry back is relatively rare in the practice of the Member States, and leads to excessive complexity".

Moreover, it proposal requires tax losses to be used in a particular order. Such particular order is the FIFO (*First In, First Out*) criterion, which states that the older losses must be used first. Note that there is implicit here a consideration of time value of money as well.

2.1.4. Tax Policy Recommendations

Based on the analysis undertaken, the following conclusions can be drawn:

- The value of the loss decreases over time. In terms of economic policy, this leads to the conclusion that carryforward should be unlimited.
- Despite this might being true in a perfect economy, in an imperfect economy this raises, in our view, administrative concerns.
- In fact, predictability of revenue is very important in terms of tax policy and that is the reason why carryforward should be limited. A period of 15 years would be advisable.
- This limited carryforward should be uncapped (i.e., no additional fixed or percentual limitations should apply to the use of the loss).
- In fact, not only should it be uncapped, but an interest should be granted to the taxpayer, in order to compensate the decrease of value of the loss over time and to compensate it for the expiration of losses, by using the adjustment coefficient issued by an independent institution, in this case, the Bank of Portugal.
- Carryback should also be introduced, as it is very useful for corporations that are to be liquidated.
- It should, however, be limited. Since it causes some trouble to the TA, as it involves the re-opening of a prior return, a short period of time would be sufficient. A window frame of 2 years, by analogy with the window frame provided for the liquidation of corporations in Portuguese law, would be sufficient.
- Nevertheless, this mechanism should only be introduced in Portuguese law in a more convenient time, namely after the end of the adjustment programme.

2.2. THE ENTITY LIMITATION

2.2.1. Theory

The entity limitation intends to avoid the transferability of losses between corporations, i.e., to ensure that the losses sustained are deducted by the same corporation that incurred such loss.

According to Miguel Correia[25], "*in order to enforce the separate tax personality of individual corporations, entity loss limitations are required so that taxpayers may not transfer losses to entities other than those that originated the loss.*"

Nevertheless, there are two core exceptions to this rule: group taxation and corporate reorganisations.

In most CIT systems, corporations organized in a group are regarded as one sole entity for the purposes of taxation. Despite varying on the degree of autonomy given to the group[26], all group taxation schemes share some traits.

Firstly, losses can be transferred within the group. The policy justification is the continuity of interest principle. Since there is a unitary management, the group resembles one big entity which will move assets (losses can be perceived as assets, otherwise there would not be loss-trafficking) to wherever they give a better return. Thus, no entity limitation must be applied here.

Secondly, most transactions within the group are tax-free. The policy justification is also the continuity of interest principle. This prevents additional tax planning related costs by allowing a wider room for maneuver.

Thirdly, all systems require some practical aspects, such as a minimum degree of ownership, a minimum period of ownership and the need for a formal application to join this special group taxation regime.

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[25] See MIGUEL CORREIA, *ob. cit.,* p. 91.

[26] A consolidation system involves the aggregation of the individual tax returns of all group members, creating one single tax base. For this reason, all intra-group transactions are disregarded. A group relief system involves the absence of a single tax base, hence the need to use either the credit or the exemption method to provide double taxation relief.

These loss limitations may or not be more restrictive when combined with the year loss limitation. There are three big scenarios: same entity, same year; same entity, other years; other entities, other years, illustrated in Figure 2, Appendix 2.

As Hugh Ault puts it "*in connection with loss carryforwards, there are often restrictions on the ability of the successor corporation to use losses against subsequently arising income. These limitations are intended to prevent the "selling" of loss carryforwards by the corporation that incurred the losses to third parties. They are typically triggered by changes in ownership of the loss corporation and/or changes in its business activities"*[27].

Another exception is corporate reorganisations. This includes mergers and divisions.

In the words of Peter Harris, a merger involves the amalgamation of shareholders of two separate corporations under one single corporation[28].

A division is due to a variation of share interests and leads to a shareholder that holds shares in one corporation before the variation, holding shares in two separate corporations after the same variation[29].

Again, the reason for the deferral of taxation is the continuity of business interest. Now, what is the continuity of business interest exactly?

The continuity of business interest basically means that, despite certain formal changes, in substance the owners of a certain investment are the same. Thus, it is not the right moment for taxability, since no real recognition has occurred. The continuity of interest test is closely intertwined with two theories: the step transaction and the substance over form/business purpose doctrines.

Under the step transaction doctrine, not all steps are necessary in order to achieve tax neutrality, i. e., tax deferral, and those are just made in order to justify the applicability of the neutrality regime.

Under the substance over form doctrine, one should pay far more attention to the substance of the operation and its final result. An example might help: despite a duck

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[27] See HUGH AULT/BRIAN ARNOLD, *Comparative Income Taxation: A Structural Analysis*, p. 393.
[28] See PETER HARRIS, *Corporate Tax Law: Structure, Policy and Practice*, p. 538.
[29] *Idibem*, p. 552.

being disguised as a dog, if it walks like a duck, quacks like a duck and smells like a duck, it is probably a duck and it would be worth to investigate. If one focused too much in the form, the duck might be perceived as a dog, but if one paid attention to the substance, one would correctly realize that it was a duck disguised as a dog.

This test was first used in US Supreme Court case *Gregory vs. Helvering* and it has evolved ever since[30]. Nowadays, the business purpose test is always accompanied by the three following tests: (i) the business commitment test, which establishes if whenever practicing the first operation, the last operation will always be concluded accordingly, (ii) the intention test, which establishes whether the parties have a plan of tax avoidance and (iii) the interdependence test, which assesses the abuse of tax deferral, whenever the actions are connected to each other only for tax reasons.

For that reason, if all of these tests are met, it will be afforded deferral to the transaction, as a business purpose will be presumed to exist for tax law purposes.

Note, however, that beyond the continuity of business interest having to be proven for tax purposes, there are also anti-abuse considerations regarding these two exceptions on the general rule of tax losses, i. e. that losses are to be sustained by the entity that has incurred such tax losses.

The continuity of interest principle intends to counteract the effects of the knife-edged approach generally used. This approach consists in denying the carryover of losses due to changes in business activity or ownership. Therefore, anti-abuse provisions were created in order to limit this harshness only to abusive situations.

Despite being an adequate solution, this solution, i.e., the existence of anti abuse provisions, can have the following policy effects: on the one hand, it can cause inefficient companies to continue its activity in an inefficient manner and, on the other hand, it substitutes a clear test by a grey-area test.

Nevertheless, these effects can easily be counteracted. Firstly, deemed economic efficiency will not last forever, as it is not possible to survive in an imperfect economy – without any State Aid – by not being efficient. The market itself will deal with that.

[30] In this sense, see TOMÁS CANTISTA TAVARES, *IRC e Contabilidade: da Realização ao Justo Valor* (2011), p. 383 *et seq.*

Secondly, the anti-abuse provisions are not that abstract. In fact, there are several types of anti-abuse provisions and some are harsher and clearer than others. Thirdly, its application can be further developed by TA praxis or by judicial decisions.

2.2.2. The Portuguese CIT system

Under the Portuguese CIT system, the entity limitation – based on the continuity of interest principle – differs regarding sole corporations or corporate groups.

For sole corporations, the continuity of interest principle focuses on the corporation's activity and management. If the corporation changes its main activity or if the ownership changes in more than 50% of the shares (either in social capital or voting rights), the losses sustained until then cannot be deducted anymore, according to article 52 (8) of CIRC. Therefore, if there is no change of activity and the change in the shares' ownership is less than 50%, the previous tax losses can still be used. Note, however, that the Portuguese legislator is not unaware of the possible deterrent effect that this may have in the economy: a request can be made to the Minister of Finance in order not to have this rule applied.

In the case of corporate reorganisations, namely mergers, tax losses from incorporated companies can be deducted against the profits of the incorporating company. However, the basic rules concerning the use carryforward of losses have to be taken into consideration, i.e., the amount of losses to be deducted cannot exceed 70% of the taxable income and all deduction of losses incurred must be operated within the 12 year window frame.

In the case of corporate divisions or split-ups, there is a particularity, as tax losses of the extinguished corporation can only be transferred to the surviving corporation within the proportion of assets transferred to that corporation. The general rules on the carryforward of losses are applicable.

As far group taxation is concerned, all abovementioned restrictions apply and some are added.

First, in order to ensure the prior identity limitation, the tax losses sustained by a corporation before joining the group are theirs to keep. The same is to say that its

previous tax losses can be used to lower the group's taxable income, but capped to that corporation's taxable income within the group.

Take the following example in order to clarify. Corporation A has prior losses of €5.000 before joining the group. After joining the group, its taxable income, which contributes to the whole group's taxable income, is only of €2.500. Thus, only €2.500 of its €5.000 can be used to offset the group's taxable income that year. This will happen as long as it takes to use its previous losses, within the limits of the general rules for the carryforward of losses.

After all previous losses have been used, the corporation A losses can now be added up to the other group members losses and then deducted to the group's whole taxable income. This is called a consolidation regime.

However, if corporation A chooses to leave the group, it cannot take its part in the group losses. Any losses sustained by a corporation under the application of this regime are for the group to keep, but cannot be used to offset the group's taxable income anymore. Nevertheless, if previous losses before joining the group are still available, those will belong to the exiting corporation.

Should a merger occur within the context of group taxation, special rules apply. In case of a merger including all corporations within a group, unused tax losses cannot be transferred to the new corporation unless there is an authorization given by the Minister of Finance! This authorization should be asked for within a 90 day period after the registry of the merger at the commercial registry. If this deadline is exceeded, all unused losses cannot be used anymore. Note, however, that the decision is not completely discretionary, as it is based on the EU law concept of "valid commercial reasons"[31]. The European concept of "valid commercial reasons" is based on the American concept of "business purpose", which was explained earlier.

All tax losses, in any of the situations above, must be deducted using the FIFO criterion – *Fist In, First Out*. The same is to say that oldest losses must be deducted first.

[31] This concept is patent in the Merger Directive (Directive 2009/133/EC) and has been extensively discussed by the ECJ. The most relevant case is Foggia (C- 126/10), available at www.eur-lex.europa.eu.

2.2.3. Comparative Analysis

Under the **US CIT system**, the entity limitation is sustained by the continuity of interest principle. This means that as long as the interest continues, the transaction is tax-free and, therefore, deferral is afforded.

This is possible for transactions either involving sole corporations or corporate groups.

Specifically, for a transaction to be tax-free – and therefore neither a gain or a loss will arise – there must be a continuity of interest. This does not happen when the main activity is changed.

If the activity or the ownership is changed, the tax-free transaction becomes automatically taxable and, consequently, the built-in gain or loss becomes taxable. The threshold is set at 50% of the control of the corporation.

This also happens in group taxation. In order to accede to the consolidation regime, there must be a degree of ownership of 80% or higher. After joining this regime, the group is perceived as a single entity, with all the benefits that arise from it, such as the free transferability of losses and assets. Nevertheless, this might constitute potential for abusive conducts. Thus, the higher the degree of integration is, the more restrictive are the applicable anti-abuse provisions.

In the case of corporate reorganisations, the rules change depending on the type of reorganization.

In fact, the US relief for mergers depends on the type of merger. There are 3 types of merger, under US law: types A, B and C[32].

The type B refers to mergers by share exchange. In this case, the merged corporation must acquire 80% of the merging corporation, expressed at 80% of both voting power conferring stock and all other classes of stock. In addition, the merged corporation must only give as consideration its voting stock. As pointed out by Peter Harris, "*the merged corporation cannot mix cash consideration with the issue of its shares or the transfer becomes taxable*"[33].

[32] For further detail, see PETER HARRIS, *ob. cit.*, p. 538 *et seq.*
[33] *Ibidem.* p.540.

The type C merger involves the merging corporation substantially transferring its assets to the merged corporation in exchange of its shares. The merging corporation must be liquidated afterwards. As noted by Peter Harris, "*the US tax administration accepts that 90% of the market value of net assets and 70% of gross assets is substantial*"[34]. Again, only stock can be given as consideration.

The type A merger refers to a statutory merger. According to Peter Harris, *"here the merged corporation can use non-voting shares and securities as consideration, and it can use even money or other property without causing disqualification as reorganization."*[35]

Note, however, that the type A merger is not by itself sufficient to qualify as a corporate reorganization under Federal tax law. Therefore, for type A mergers, other requirements must be met. First, there must be a plan of reorganization. Second, there must be a business purpose. Third, there must be a continuity of interest by the shareholders.

For de-mergers, the focus is to provide relief only if there is a continuity of interest. As such, among other criteria, both distributed and distributing companies have to continue pursuing active business for at least five years and reference is made to an 80% threshold. Nevertheless, the distribution does not have to be proportional.

Under the **Australian CIT system**, there is merger relief when the 80% of one corporation is acquired by other corporation, resulting in 80% of the voting power. Despite having to be a direct acquisition, the ownership of other group members counts for this purpose.

An example might help to clarify this situation. Corporation A is owned in 60% by corporation B. Corporation B, in turn, is part of a corporate group with corporation C. Corporation C now buys 20% of corporation A. Now, 80% of corporation A is owned by the corporate group. Therefore, merger relief is provided.

Note that there are not any limitations regarding consideration and that mergers by fusion are only possible if allowed by court.

[34] *Ibidem*, p. 540.
[35] *Ibidem*, p. 541.

For de-mergers, a distinction has to be made. If the de-merger is done by asset transfer, it is only possible to obtain relief if the transaction is carried out within a fully owned group. On the other hand, the de-merger is done by distribution, "*if the head entity and its 20% subsidiaries (by income, capital or voting) distribute at least 80% of their shares in one of those subsidiaries to the shareholders of the parent corporation.*"[36]

Further, other requisites have to be met. Firstly, 50% or more of the capital assets transferred have to be used in the business. Secondly, there must be a proportional distribution between all parties involved in the transaction. Lastly, only shares can be given as consideration,

Germany has a different approach when it comes to mergers. Although shareholders may receive other forms of consideration than shares, relief is only possible if the consideration is exclusively formed by shares. Furthermore, it is necessary that the merged corporation receives the majority of the voting rights' of the merging company in order for relief to be provided. Germany has a separate regime for mergers by fusion.

Germany has a peculiar approach when it comes to de-mergers. In fact, de-mergers done by distribution of shares are not expressly covered in law. Moreover, there is not a minimum level of holding of shares to be met.

The merger by incorporation is not regulated in tax law, but in a "Reorganization Law". According to this law, the underlying concept is the "transfer of business", which can be done by a split-off, a spin-off or a partial transfer. Under the Reorganisation Law, all members of the distributing company must approve the operation and, if it is not a proportional operation, it must be approved by unanimity.

The reorganization rules in Germany are heavily complemented with anti-abuse provisions, as noted by Peter Harris[37]. Firstly, the relief is denied if the business division to be transferred was created less than three years before the merger. Secondly, the merger cannot be used as a starting point for the sale of shares, i.e., there must be a shareholder continuity of interest. Thirdly, merger relief can be retrospectively denied in within five years of a de-merger if more than 20% of the shares in the distributed

[36] *Ibidem*, p. 556.
[37] *Ibidem*, p. 557.

company are sold. Lastly, there is no merger relief when the shares in the distributing corporation have existed for less than five years.

Note that Germany uses the continuity of interest test allied to a time limitation in order to prevent abuse. If the transaction is of *bona fide*, there will be nothing to fear and all requisites will be easily met.

The **UK CIT system**, just like the Australian one, does not accept a merger by fusion, unless authorized by court. However, relief for mergers by share exchange might be provided in the following cases, according to Peter Harris[38]:

a) After the merger the merged corporation holds "more than 25% of the ordinary share capital" of the merging corporation.
b) The merged corporation issues its shares in the exchange "as the result of a general offer" made to shareholders of the merging corporation and "in the first instance on a condition such that if were satisfied [the merged corporation] would have control of [the merging corporation]".
c) After the merger the merged corporation holds the "greater part of the voting power" of the merging corporation.

Both ordinary share capital and voting power thresholds include before and after the merger shares. Note that only direct ownership counts for this effect. Furthermore, *bona fide* commercial reasons are necessary for relief to be applied.

Note that the UK also provides relief when a corporation transfers part of its business to another corporation and, as a result, the receiving corporation issues shares to shareholders of the transferring corporation. Unlike the US system, the UK does not impose the transferring company to be liquidated in order to provide relief.

In the UK, de-merger relief is only granted when carried out in a 75% group. Note that this group may already exist or be immediately formed when a company, the parent company to be, acquires more than 75% of another company, the subsidiary company to be.

[38] *Ibidem*, p. 543.

Also, the distributed shares cannot be redeemable, i.e., cannot be converted into cash and almost all of consideration given in exchange must be shares.

Additionally, the distributing company can only retain a minor interest in the trade or subsidiary transferred. This means that almost all shares referring to the object of transfer must be distributed. Note that despite not being needed for the distribution to be proportionate, it would be advisable in order to fall outside of the scope of anti-abuse provisions.

Last, but not least, there must be a continuity of commercial purpose, i.e., the business must be effectively carried out in the future.

The relief consists, in all systems, of not triggering taxation. Therefore, the merged or divided corporation must take the assets exactly as they were, i.e., the tax value will not have to change. This is called the carryover basis mechanism.

If relief was not granted, there would be a step-up, i.e, the asset's fair market value would be the tax value for the acquirer and the difference between the acquisition cost and the sale price would be a gain or loss for the seller.

2.2.4. Tax Policy Recommendations

Based on the analysis undertaken, the following conclusions can be drawn:

- There are 3 manners to treat the entity limitation of tax losses: (1) losses can be seen as saleable assets, allowing for them to be transferred to any other entity, (2) losses can only be used by the loss making corporation or (3) losses are for the corporation that sustains them to keep, despite being exceptions to this rule.
- In most CIT systems, there are two exceptions to the rule mentioned in (3) above, such as group taxation and corporate reorganisations.
- In Portugal, the entity limitation is well balanced with the mentioned exceptions, which are similar, despite varying in certain aspects, throughout the world.
- After the reform, the Portuguese CIT system and its treatment of the entity limitation of tax losses is easy enough on the economic operators, while providing adequate safeguards against abuse.

2.3.THE CHARACTER LIMITATION

2.3.1. Theory

The character limitation lies in the divide between business or ordinary income and capital income.

Business income derives from the normal activity of a corporation. Take "Pastéis de Belém" as an example. The profit made by selling "pastéis" by this well-known pastry shop and factory is business income, as selling the famous "pastéis" is its main activity.

In general, capital income derives from the sale of an asset. Let's continue using our pastry shop and factory example. If the pastry shop and factory sells the building in which it is located or one machine, the income resulting from that sale should, in principle, be classified as capital income.

According to Michael Stepek[39], *"the distinction between capital gain and ordinary income, with all its complexity, must be retained unless an alternative tax system can eliminate the need for the realisation requirement."* The same is to say that this divide intends to disable cherrypicking. The need to prevent cherrypicking arises from the fact that capital losses can be selectively triggered, thereby allowing for the reduction of taxable income. This is why, under a CIT system that has formally implemented the capital/ordinary income divide, losses can only offset gains deriving from the same type of income.

This divide between the two categories of income has economic justifications: one theoretical and one practical.

From a theoretical point of view, capital gains should be taxed only to the extent that there has been a change, during the holding period, of the anticipated flow of income that the asset may generate in future years. If no change has occurred, such gains should not be subject to tax[40].

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[39] See MICHAEL STEPEK, *The Tax Reform Act of 1986: Simplification and the Future Viability of Accrual Taxation* (1987), p. 784.
[40] See MIGUEL CORREIA, *ob. cit.*, p. 89.

From a practical point of view, only the capital income requires to record previously taxed amounts, i.e.., as previously discussed, through the mechanism of tax basis. The record of pre-taxed amounts is not generally necessary in business income.

The need for this formal divide is criticised. Four major arguments are put forward against this divide, according to Michelle Cecil[41].

First, this divide automatically assumes that all taxpayers have unrealised gains and losses. Needless to say, this is simply not true.

Secondly, it also automatically assumes that if this divide did not exist, taxpayers would start selling loss assets. Once again, human behaviour is hard to predict and, despite taxes playing a huge part in a corporation's life, they are not the only factors to be taken into consideration. Sometimes, business motives surpass tax motives.

Thirdly, the subjacent cherrypicking rationale implies that taxpayers would be constantly generating new loss assets. Again, this cannot be proved.

Lastly, "*disallowing the deductibility of capital losses (i. e., true economic losses) to taxpayers with no capital gains may discourage investment.*"

The distinction between the two types of income – business and capital – can either be formal or practical. Normally, common law systems have a formal distinction, whereas Continental European systems have a practical distinction[42].

One consequence of implementing a formal distinction is the need to classify all assets, subsuming them into one of these two categories.

Despite not having a formal divide, most continental Europe countries have *"several limitations on the use of losses accrued on the transfer of capital assets, which pursue a similar policy rational"*[43]. A detailed analysis of a country that has not implemented a formal distinction between business and capital income – Portugal - is carried out in the next section.

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[41] See MICHELLE A. CECIL, *Toward Adding Further Complexity To The Internal Revenue Code: A New Paradigm For The Deductibility Of Capital Losses* (1999), p. 1118.
[42] For a detailed analysis of this divide in other countries that are not analysed in this study, see HUGH J. AULT/ BRIAN J. ARNOLD, *Comparative Income Taxation: A Structural Analysis*, Kluwer Law International (2010).
[43] MIGUEL CORREIA, *ob. cit*, p. 90.

2.3.2. The Portuguese CIT system

Not having a formal divide between business and capital income, does not mean that the character limitation is entirely absent from the loss limitation rules of the Portuguese CIT system.

In fact, there is a set of rules implementing restrictions of this kind. The same is to say that the Portuguese CIT system does care about the character limitation, but in a more practical way, only ensuring the limitation in itself and not imposing a formal divide. The main justification for this is the model of tax accountancy used in Portugal: there is a partial dependency between regular accountancy and tax accountancy, in the sense that, when filing the tax return, the taxpayer uses its regular accountancy balance sheet as a starting point and refines it by applying the tax accountancy rules to get its taxable income. In sum, as for accounting purposes there is no need to make any distinction of this kind, there is also no need to do so for tax purposes.

This practical limitation is ensured by the following set of rules. Note that all provisions are about the use of shares and that shares are always perceived as capital assets.

According to article 51-C (3), capital losses arising on a stock transfer when rollover is not applicable in corporate reorganisations, are excluded from taxable income.

Article 23-A (3) disallows the deductibility of expenses associated with certain transfer of stock between related entities or entities that are domiciled in a tax haven[44].

[44] Note that there is a very close link between tax losses and transfer pricing regulations. In this sense, see OECD Report, *ob. cit*, p. 10 ("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.").

2.3.3. Comparative Analysis

Under the **US CIT system**, a formal divide between capital assets and business income is into force.

According to IRC section 1221, a capital asset is defined by exception. That means that all capital assets are categorically defined and, if the type of income does not meet the given list, it is not a capital asset. If the income arising from a sale or exchange meets the list, it will be a capital asset and the transaction result will be either a capital gain or loss.

However, if the type of income does not meet the list, it is immediately a business income gain or loss, according to IRC sections 64 and 65.

Under the **UK system**, according to Peter Harris, "*there are rules specifying when a person with a loss from one activity may set that loss against the profits from another activity. This is commonly referred to as "sideways relief"*"[45].

Business losses are losses deriving from the business activity. Capital losses derive from the sale of capital assets. However, as the UK has a schedular system, business losses are dealt under Corporate Tax Act 2010 and capital losses are dealt under Taxation of Capital Gains Act 1992.

Nevertheless, all income is aggregated for corporate taxation purposes. According to Hugh Ault, *"in formal structure, the capital gains tax is a separate tax for individuals but part of the corporation tax for capital gains realized by corporations"*[46] . Business losses can be set against either type of income – business or capital income – but capital losses can only be set against capital income.

Such formal or even practical division is absent from the **CCCTB** proposal. Therefore, it can be assumed that no consensus on this matter was reached at the European level.

2.3.4. Tax Policy Recommendations

Based on the analysis undertaken, the following conclusions were reached:

[45] See PETER HARRIS, *ob. cit.*, p. 114.
[46] See HUGH AULT/BRIAN ARNOLD, *ob. cit.*, p. 243.

- This type of limitation is needed from a tax policy perspective.
- It can be ensured by either carrying out a formal or a practical divide.
- The formal divide is understandable and maintained only for historical reasons.
- Therefore, if the outcome is virtually the same, there is absolutely no need to change the way the character limitation on tax losses has been dealt until now under Portuguese CIT law.
- Note that the European consensus, as can be seen in CCCTB, and in most Continental European tax Laws, has been not to adopt this limitation formally.

2.4. RISK-TAKING AND LOSSES: A RISKY BUSINESS?

There is a relationship between the treatment of tax losses under a CIT system and entrepreneurial risk-taking[47]. In a perfect world, in a perfect market, tax considerations would not influence the strategic decision-making of investments.

However, we live in an imperfect economy and, so, tax considerations sometimes prevail over pure business considerations. The same is to say that an investment will only be carried out if it is likely to succeed or if it does not succeed, the tax losses deriving from such investment are usable. The underlying concept here is "*risk*" and it can be defined, in very broad terms, as the probability of obtaining a smaller return than the yield[48].

Thus, although existing research is not absolutely consensual on this issue, the Government may, in principle, decide whether it wants to encourage or discourage corporate risk-taking. It can do so by modifying the characteristics of the loss offset system, as it is a matter of tax policy. Note, however, that pure neutrality against risk is impossible under a realisation-based system. As noted by Scarborough, *"if losses were allowable without limit, taxpayers would be encouraged to make risky investments so*

[47] See MUSGRAVE/DOMAR, *ob. cit*, p. 391.

[48] *Ididem*, p. 388 ("In every investment decision the investor must weigh the advantage of a greater return – or yield – against the disadvantage of a possible loss – or risk. These two variables serve as tools for the analysis of the problem.").

that they could selectively realize losses. If losses were limited, however, risky investments could give rise to unusable losses and thus [risk] would be discouraged"[49].

Regarding tax policy objectives – encouraging or discouraging risk-taking - , three loss relief scenarios are theoretically possible[50]. Despite these scenarios being analysed hereunder, Appendix 2 contains diagrams that illustrate the possible tax policy options. In order to understand the following explanation, figure 1 is the most self-explanatory.

The first and most terrible scenario is the absence of loss relief. Simply put, if this scenario were to be into force, corporate taxpayers would always be taxed whenever the corporation generated profits. It would, on one hand, be administratively simpler and, in principle, deter excessive risk. As noted by Domar and Musgrave, *"since, without loss offset, the yield is cut, while risk is unchanged, the competition for risk-taking is reduced (...) practical evidence would indicate that the investor is likely to shift in the direction of less risk."*[51] On the other hand, it would result in a double taxation of capital. Double taxation of capital is likely to arise in this scenario since, as pointed out by Campisano and Romano, *"When a firm generated losses its costs of producing income will not be fully accounted for by the tax system unless the loss can be deducted, and the nonavailability of a deduction against zero income effectively constitutes a tax on the loss firm's capital… But since that capital has been taxed once before, prior to its investment in the firm, the business's inability to recover the loss for tax purposes results in a double taxation of the capital."*[52]

The other two scenarios refer to loss relief options, one providing full refund and the other not providing any refund whatsoever, but allowing for the carryover of losses.

The second scenario – on the opposite side of the loss relief spectrum - is providing loss relief coupled with full refund. This system is normally called "recoupment of losses"[53]. According to this system, the Government would reimburse the taxpayer for the loss in the same year that the loss was incurred. According to its proponents, this system would only speed up the use of the loss and the only difference between this system and a

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[49] See ROBERT H. SCARBOROUGH, *Risk, Diversification and the design of loss limitations under a realisation income tax*, New York (1993), p. 717.
[50] See MIGUEL CORREIA, *ob. cit*, p. 245 *et seq.*
[51] See MUSGRAVE/DOMAR, *ob. cit.*, p. 390.
[52] See CAMPISANO/ROMANO, *ob. cit.,* p. 717.
[53] See CAMPISANO/ROMANO, *ob. cit.,* for a thorough defense of this system.

carryover system is timing. Nevertheless, losses normally are not fully used under a carryover system. Thus, this system would encourage risk-taking, as the Government spreads the risk burden between itself and the taxpayer[54]. Moreover, in a more economic oriented analysis, this system may help to produce cyclical stability and increase the supply of external finance, as it is a means to capture foreign direct investment[55]. However, this system entails an impact in revenues and a potential for abusive aggressive tax planning[56]. Despite being at first sight an excellent option, a pragmatic analysis discourages the implementation of such a system. As Maureen Donnelly and Allister Young[57] lucidly point out, *"the conceptual advantage of a policy recoupment is not enough to overcome the more pragmatic need to preserve the business tax base and survive the political realities of corporate tax policy formulation."*

The third and last system is loss relief without refund, but coupled with carryover of losses. It is, thus, an intermediate tax policy choice between the previous systems. According to this system, losses are not refundable, but can be used to offset taxable income of other years[58]. As the carryover of losses is granted, all limitations studied above apply. Therefore, the carryover of losses is subject to year, entity and character limitations.

The entity limitation spectrum is very broad, as it can go from an extreme where only the entity that sustained the loss can use it to another where the entities are able to trade losses among themselves, as if losses were regular saleable assets.

Note however, that losses can be perceived as saleable assets, but only in theory, since there are many costs associated with this kind of operation. In fact, as Miguel Correia points out, *"due to the transaction costs associated with the market mechanisms that*

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[54] See MUSGRAVE/DOMAR, *ob. cit.,* p. 389 ("by imposing an income tax on the investor, the Treasury appoints itself as his partner, who will always share on his gains, but whose share in his losses will depend upon the investor's ability to offset against other income").

[55] See MIGUEL CORREIA, *ob. cit*, p. 248 ("Since the potential tax subsidy could be pledged to repay debts in case of default on loans, it should reduce the risk to lenders and, thus, increase their willingness to lend.").

[56] *Idibem*, p. 249, ("When faced with the realisation-based nature of the current CIT system, the corporate taxpayer may engage in lock-in and lock-out behavior, as well as in tax planning operations to abusively generate tax losses").

[57] See DONNELLY/YOUNG, *ob. cit*., p. 445.

[58] Another possibility under this system is to use losses as saleable assets.

are required for this system to operate, this solution does not ensure full refundability. That is, to encourage the transferee to acquire the loss on the open market, the tax value of the loss will most likely to be discounted. Thus, the transferor corporation should not realize the full value of the loss. In turn, the transferee should have a gain on the transaction to the extent that the tax savings are less than the cost of purchasing the loss. This inefficiency is compounded by the transaction costs incurred to implement this transfer."[59]

Notwithstanding, in order for losses to be transferrable between corporations – either related or not – the question of loss ownership must be addressed by the CIT system. In fact, if the loss is considered to belong to the corporation, it should not be transferrable. By the same token, if the loss is considered to belong to the shareholder or to the corporate group (as a "shareholder"), losses should be transferrable to either the physical shareholder, the corporate group or to other entity, provided some kind of consideration, presumably cash, is given in exchange.

Allied to the entity limitation, there may be year limitations, which have been dealt with extensively above, as well character limitations.

In appendix 2, figure 2 shows how the combination of the entity and year limitation can be put into a spectrum, as well as the different possibilities when combining the two types of limitations. In this figure, it is assumed that the character limitation is underlying. In fact, the CIT may be more restrictive, only allowing losses to be used by the company which sustained them in the exactly same year the losses were sustained, or it can be not restrictive at all – and we are assuming that carryforward or carryback are limited in time, even for generous periods of time – allowing for a sale of losses over long periods of time.

The impact of the carryover system on risk-taking depends on the profile of each taxpayer. If the taxpayer is more able to manipulate the rules, it is likely to accumulate less unusable tax losses and, therefore, be less discouraged into taking risky investments. If, on the other hand, the taxpayer is less able – or not able at all – to manipulate the rules, its propensity to accumulate unusable tax losses is higher and, to that extent, it will be discouraged to invest in risky ventures.

[59] See MIGUEL CORREIA, *ob. cit.*, p. 250.

There are ways to lower the impact on risk associated with unusable losses.

The first one is hedging, which consists in making investments in opposite senses. For example, making an investment with a guaranteed return that can fully or partially eliminate the risk of not getting anything from the other investment, which must be risky[60].

The second way is to use the group taxation rules into the taxpayers' favour by (i) entering into a conglomerate that is diversified[61], in the same logic of hedging and (ii) entering into a conglomerate that is old as, according to Robert Musgrave, "*loss carryback gives an old corporation (i. e., a corporation with past net income) the certainty of possible loss offset, thus placing it in a very advantageous position as compared with a new company [that is, a company without past net income]".* This is because the carryback should result in a full refundability of losses, whereas the carryforward should only result in partial refundability, due to loss of interest and, where carryforward limits apply, expiration. Therefore, it would be of great advantage to enter into a pre-existing conglomerate.

In conclusion, the characteristics of the CIT system, when it comes to loss limitations, as studied until now – within a closed economy context – may impact the degree of risk-taking in the corporate sector, as prescribed in the Government's tax policy. By the same token, the degree of risk-taking carried out by each taxpayer depends on its specific profile and willingness to adapt to the CIT loss limitations rules[62].

2.5. SUMMARY OF CONCLUSIONS: CLOSED ECONOMY CONTEXT

Considering all the analysis in a closed economy context undertaken until this point, the following tax policy recommendations can be given:

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[60] See SCARBOROUGH, *ob. cit.,* p. 685.

[61] See CAMPISANO/ROMANO, *ob. cit.,* p. 719.

[62] There are other ways to increase corporate risk-taking, such as altering the tax rate. Nevertheless, loss offset rules are predominant. In this sense, see LANGENMAYR/LESTER, *Taxation and Corporate Risk-Taking*, p. 34 ("To the extent that governments want to encourage risk-taking, the use of loss offset rules, particularly carrybacks, may provide incentives. The use of tax rate to encourage risk-taking should be viewed more critically, as changes in rates may provide incentives only for firms that can expect to offset losses. Moreover, tax rate increases are likely to have adverse effects on a country's ability to compete for foreign direct investment").

- The value of tax losses decreases over time. In terms of economic policy, this leads to the conclusion that carryforward should be unlimited in time, in order to compensate the taxpayer.
- Despite this being true in the absence of budgetary constraints, in an economy like ours, which is very fiscally constrained, this is quite impracticable. In fact, predictability of revenue is currently very important and that is the reason why carryforward should be limited. A period of 15 years would be advisable.
- As soon as budgetary considerations are relaxed, this limited carryforward should be uncapped. In fact, not only should it be uncapped, but also an interest should be granted to the taxpayer, in order to compensate the decrease of value of the loss over time and to compensate it by the expiration of losses, by using the adjustment coefficient issued by an independent institution, in this case, the Bank of Portugal.
- Carryback should also be introduced, as it is very useful for corporations that are to be liquidated. It should, however, be limited in time. As it causes some trouble to the TA, since it involves the re-opening of a prior tax case. A window frame of 2 years, by analogy with the window frame provided for the liquidation of corporations in Portuguese law, would be sufficient. Nevertheless, this mechanism should only be introduced in Portuguese law in a more convenient time, namely after the end of the adjustment programme.
- There are three manners to treat the entity limitation on tax losses: (1) losses can be seen as saleable assets, allowing the transferability to any other entity, (2) losses can only be used by the loss making corporation or (3) losses are for the corporation that sustains them to keep, despite being exceptions to this rule.
- In most CIT systems, there are two exceptions to the rule mentioned in (3) above, such as group taxation and corporate reorganisations.
- In Portugal, the entity limitation is well balanced with the mentioned exceptions, which are similar, despite varying in certain aspects, throughout the world.
- After the reform, the Portuguese CIT system and its treatment of the entity limitation of tax losses is easy enough on the economic operators. Further, we see no need to change the way the character limitation on tax losses has been dealt until now under Portuguese CIT law.

- The characteristics of the CIT system, when it comes to loss limitations, as studied until now – within a closed economy context – may impact the degree of risk-taking in the corporate sector, as prescribed in the Government's tax policy. Further, the degree of risk-taking carried out by each taxpayer depends on its specific profile and willingness to adapt to the CIT loss limitations rules.

3. OPEN ECONOMY ANALYSIS

The purpose of this section in merely to outline a broad conceptual framework for analysis of the Portuguese legislation in an open economy context, as each of the topics concerned – cross-border use of losses and exit taxation – could be the subject of a separate thesis by itself. Therefore, the analysis of the EU system on both topics is only carried out to the extent necessary to assess the Portuguese legislation. In contrast to the preceding section of this thesis, the discussion does not aim at comprehensiveness, especially as far as EU law and jurisprudence is concerned, but merely at identifying core policy issues.

3.1. Theory

As mentioned before, each of the topics alone is material for a thesis *per se*. Therefore, this study will concentrate on the core conclusions that can be withdrawn from existing research in order to have a background for analysis of the Portuguese legislation.

Before delving into much detail, a distinction between cross-border use of losses and exit taxation must be entailed.

According to Ben Terra and Peter Wattel[63], exit taxes serve to secure taxation in respect of unrealised income accrual which may otherwise escape taxation in the accrual jurisdiction as a result of the taxpayer leaving that jurisdiction. In turn, cross-border use of losses means that losses incurred in one country, which is not the corporation's State of Residence, may still be used in the Residence State ("Home State").

Note that, despite both concepts being connected with the freedom of establishment, they are not the same, as they pose different problems. Exit taxation is a restriction in

[63] See BEN TERRA/ PETER WATTEL, *European Tax Law*, p. 955, Kluwer Law International (2012).

the sense of freedom of movement of corporate taxpayers, whereas cross-border use of losses is a restriction to the freedom of establishment in the sense that it influences the way corporate groups are organized, as will be explained below.

Moreover, both concepts have implications on losses. On one hand, cross-border use of losses refers to accumulated – and, therefore, realised – losses in one country. On the other hand, exit taxation refers to built-in losses, i.e., losses that have not yet been realised.

3.1.1. Cross-border use of losses

Currently, in the EU, there is an absence of a cross-border loss relief system. Thus, *"the offset of losses is generally limited to the amount of profits generated in the Member State in which the investment is made."*

This distorts business decisions within the internal market in four different ways, as pointed out by the European Commission[64]: (i) it favours domestic investments; (ii) it favours cross-border investments in larger Member States only; (iii) it favours large enterprises over Small and Medium Enterprises (SME); and (iv) it influences the choice between a Permanent Establishment (PE) and a subsidiary as a form of investment.

This distortion leads to higher prices for consumers and businesses, loss of welfare and lack of efficiency.

So, how exactly does the absence of cross-border loss relief affect the freedom of establishment? It does so by influencing the way corporate taxpayers organise their groups, as there are different regimes applicable for branches and subsidiaries.

The distinguishing factor between branches and subsidiaries is the existence of a different and separate legal entity. A subsidiary is a legal entity that is distinct from its parent company. In contrast, a branch or a Permanent Establishment ("PE") does not have legal existence on its own, being simply an extension of the parent company. This means that, as a rule, tax losses deriving from a branch can be used in the parent company's Home State, as it is a flow-through entity, whereas the tax losses deriving

[64] See Communication form the Commission to the Council, the European Parliament and the Economic and Social Committee on the Tax Treatment of Losses in Cross-Border Situations (Com (2006) 824 final), p. 3.

from a subsidiary are much more difficult to be transferred to the parent company's Home State, as it has a legal existence of its own.

Note, however, that despite the branch's tax losses – which is the same as saying the corporation's foreign tax losses – being accepted in the Home State, further complexity may arise as the Home State may either accept the calculations made according to the Host State tax rules or it may impose a re-calculation of the tax losses according to its own set of rules.

In general, the losses deriving from a PE must be taxed first by the Host State, according to the source principle. Consequently, the Home State must use one of the following methods to provide relief: credit method or exemption method.

When using the credit method, the taxes paid abroad are credited against the part of the domestic tax levied on the income tax abroad. Any loss will be taken into consideration when determining the worldwide income.

The exemption method excludes foreign income taxed in the Host State from the tax base of the Home State. The exemption method can provide temporary loss deduction or not. When the Member State allows temporary loss deduction of the losses (since profits are always exempt) sustained by a PE situated in another Member State, these losses are generally recaptured once the PE returns to profitability. This is called the recapture mechanism and ensures tax cohesion, as it prevents losses from being used twice. Alternatively, the Member State may decide not to grant any loss deduction since the results of PE are also not taken into consideration.

Note that the set off of losses incurred by a PE must be against the profits of the head office. This is called vertical upwards setting off, as it is generally not possible to set off the head office losses against the PE's profits, since the PE is not a separate legal entity.

The European Court of Justice (ECJ)[65] has dealt extensively with cross-border loss offset.

[65] All the ECJ Case Law mentioned throughout this study is up to date as to March 2014.

The following cases are especially noteworthy, as they offer different perspectives on this issue, referring to PE or branches. As summarized by the European Commission[66]:

"In Futura[67], the ECJ looked at the situation from the perspective of the host State of the permanent establishment, finding that the territoriality principle could justify limiting the amount of loss carryforward available in that State to the losses that had an economic link with income earned there.

In AMID[68], adopting a home State perspective, the ECJ found that the exemption from taxation of Luxembourg permanent establishment profits under Belgium's double tax agreement (DTA) with that country did not establish, in respect of loss relief, an objective difference between the situation of a Belgian company with an establishment (branch) in Belgium. In the absence of justification, different treatment of those two companies as regards the deduction of losses was contrary to the freedom of establishment and could not be accepted."

Recently, in *Philips Electronics*[69], the ECJ ruled that losses from branches must be taken into consideration at the head office's Home State if the branches are having its fundamental freedoms restricted or losses cannot be used anymore as they have already expired. This case applies the Marks and Spencer doctrine, which will be explained later, but only referring to branches instead of subsidiaries.

Another way to distort freedom of establishment is the issue of cross-border loss relief between companies and its foreign subsidiaries.

As stated previously, there is generally an absence of cross-border loss relief in this context. If the situation occurred at the domestic level, relief would have been automatically granted.

The most emblematic case regarding cross-border use of losses is *Marks and Spencer*[70] where the ECJ ruled that there was a restriction to the freedom of establishment, but it

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[66] See Communication form the Commission to the Council, the European Parliament and the Economic and Social Committee on the Tax Treatment of Losses in Cross-Border Situations (Com (2006) 824 final).

[67] Case C-250/95, available at www.curia.eu

[68] Case C-141/99, available at www.curia.eu

[69] Case C- 18/11, available at www.curia.eu

[70] Case C- 446/03, available at www.curia.eu

was justified by three factors: the balanced allocation of taxing powers, the need to prevent losses from being used twice and the need to fight tax avoidance. Nevertheless, this case failed the proportionality test, as the ECJ ruled that, if the subsidiary's Home State possibilities to deduct such losses had been previously exhausted, the parent company's Home State had to take into consideration such losses. In fact, as noted by João Félix Pinto Nogueira[71], the ECJ clarified this impossibility rule: (i) the non-resident subsidiary has to have exhausted all possibilities for deduction in its home state and (ii) the non-resident subsidiary cannot, by itself or by a third party, offset those losses in future tax returns.

Therefore, whenever dealing with cross-border losses, the Marks and Spencer doctrine applies: cross-border loss relief only has to be granted by the parent company's Home State in case of terminal losses, i.e., losses that cannot be used anymore in the subsidiary's Home State, as all possibilities of loss deduction have been exhausted.

Although the concept of terminal losses has been explained by the ECJ, thus being considered an autonomous concept of EU law and, therefore, interpreted unanimously, the TA are having a concerted action in considering terminal losses only the losses deriving from liquidations. However, the TA are not alone in this. In fact, the German Federal Tax Court has taken the position to consider terminal losses only the losses deriving from the closure of a foreign business and not to consider expired losses at all for this purpose[72].

However, as pointed out by Ben Terra, *"that is to asymmetrically assert wider taxing jurisdiction than it had symmetrically and sovereignly chosen to do[73]".*

In fact, the ECJ confirmed Ben Terra's opinion. In *Gilly*[74], it is said that forcing a Member State to refund tax on domestically sourced income to compensate for a tax disadvantage suffered in other Member State, and therefore outside its taxing jurisdiction, would jeopardise its jurisdiction. One might add that this may cause a problem of balanced allocation of taxing powers, as it is quite disproportionate to allow a State, any State, to tax in another State's jurisdiction.

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[71]See JOÃO FÉLIX PINTO NOGUEIRA, *Direito Fiscal Europeu – O Paradigma da Proporcionalidade*, p. 435.
[72] See BEN TERRA, *European Tax Law*, p.1028.
[73] *Ibidem*, p.1029.
[74] Case C- 336/96, available at www.curia.eu

Despite being an alternative to the absence of cross-border loss relief, the Marks and Spencer doctrine isn't enough to fulfill the purpose of EU law. Would it be enough to apply the same system as applied domestically to cross-border group taxation within the EU? The answer would be "No" and let's see the reasons why.

There are four possible systems of cross-border group taxation: group relief, intra-group contributions, pooling and full consolidation systems.

Under a group relief system, a loss from one group member can be surrendered to a profitable group member.

Note that, according to the ECJ on *Oy AA*[75], a subsidiary cannot contribute its profits to its loss-making parent company. The reverse, on the other hand, should be possible.

Under an intra-group contribution system, only profitable entities can surrender profits to loss-making entities.

The ECJ has dealt with this type of system on *X holding*[76]. The ECJ ruled that intra-group loss compensation could be achieved automatically if the Member State applying such regime extended it to include companies located in other Member States but part of a group in which the parent company was located in that particular Member State.

In a pooling system, all group results are aggregated at the parent company level. Further, note that since not all EU member States adopted the Euro, contingencies may arise due to currency exchanges on losses to be surrendered. As the ECJ ruled on *Deutsche Shell*[77], this a contingency and it is no justification for preferential treatment.

In a full consolidation system, all group members' personality is disregarded and the group is regarded as one sole entity.

The reason why the extension to any of these regimes throughout the EU would not work is the absence of an explicit mechanism of recapture of losses. This would only work if the losses were terminal; if the losses were only temporary, it would be very complex. Moreover, it would be very difficult to extend some particularities of a

[75] Case C- 231/05, available at www.curia.eu
[76] Case C- 337/08, available at www.curia.eu
[77] Case C- 293/06, available at www.curia.eu

domestic system, as it is generally designed for one particular jurisdiction, rather than to an entity like the EU.

Keeping this in mind, the European Commission proposed three alternative systems[78], which can be described as follows:

A definitive loss transfer system, which can be also applicable to profits, where there is no recapture mechanism. Therefore, the Member State absorbing the losses must be compensated by the Member State in which the loss-making company resides. This system may also be called intra-group loss transfer.

A temporary loss transfer system, which was proposed in the 1990 Directive[79] and allows for immediate relief at the parent company level. This avoids cash-flow disadvantages. According to this system, a loss incurred by a subsidiary resident in another Member State, which was deducted from the result of the parent company, is recaptured once the subsidiary returns to profitability. Hence, a temporary loss relief is granted, characterized by a deduction and reintegration of the same loss.

However, that there may be some issues associated with this mechanism, as noted by Emma Sandberg Thomsen[80]: what if the subsidiary company never shows profits again or is sold before return to profitability? What if the subsidiary's Home State does not provide rules to deduct losses over time?

Nevertheless, as noted by Ben Terra[81], this mechanism also presents significant advantages, as the reinstatement mechanism "*erases the foreign profit for tax relief purposes, meaning that the foreign profit will be fully taxed, exactly as a comparable domestic profit. The cross-border and domestic situations are thus treated alike*".

Lastly, a system of consolidated profits in which the taxpayer has the choice to include all or selected subsidiaries only. According to this system, profits and losses of the

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[78] See Communication form the Commission to the Council, the European Parliament and the Economic and Social Committee on the Tax Treatment of Losses in Cross-Border Situations (Com (2006) 824 final), p. 6.

[79] The Proposal for a Council Directive concerning arrangements for the taking into account by enterprises of the Losses of their Permanent Establishments and Subsidiaries situated in other Member States (COM (1990) 595 final).

[80] See EMMA SANDBERG THOMSEN, *Tax Treatment of Losses in the European Union – Possibilities and Challenges*, Lund (2005).

[81] See BEN TERRA, *ob. cit.*, p. 1037.

chosen subsidiaries over a period of time are taken into consideration at the parent company's level. Note that, under this regime, consolidated subsidiaries would be treated as Permanent Establishments, i.e., they would lose their individuality.

Should the taxpayer choose to include only some subsidiaries, thus entering a selective scheme, it would require less documentation, but it would be more vulnerable to aggressive tax planning.

Should the taxpayer choose to include all subsidiaries, thus entering a comprehensive scheme, the overall financial position will be taxed in the parent company's Home State. However, this would increase compliance costs. Note that the credit method would be used to avoid tax arbitrage, i. e., the exploit of loopholes in tax legislation, deriving from the inclusion in this system.

More recently, the ECJ dealt with the problem of cross-border losses, in the context of mergers, in *A Oy*[82]. Namely, what happens to non-resident subsidiary's prior losses after a merger? The ECJ ruled that the Member State does not have to allow the deduction of prior foreign losses after the merger, as it can do at domestic level. Unless, just like in Marks and Spencer, the losses are terminal, i. e. the exhaustion test is met.

The CCCTB also dealt with cross-border use of losses. In fact, in article 55, the proposed Directive allows for the taxpayer to choose at which corporate level it desires to create a corporate group. From that level under, all group entities must be included. As per article 57 (1) group members retain their separate legal identity, despite their results being pooled. The balance would then be apportioned among them. Pre-consolidated losses can be brought into the group, but can only be offset against the taxpayer's share of the tax base, as laid out in article 64. Upon the exit of the group, losses are for the group to keep, as per article 69, unless (i) if the group itself terminates, then the losses are apportioned by all entities or (ii) if there is business reorganization involving other group, then the losses are apportioned by the entities that leave that group. If the business reorganization is carried out intra-group, there will be no tax consequences, unless the apportionment formula is distorted. In such case, there is deemed a fictitious branch in the company's transferring state, according to article 70 (2).

[82] Case C- 123/11, available at www.curia.eu

3.1.2. Exit taxation

Exit taxation results from taxing residents on a realisation basis and trying to apply such logic when residents depart. As it is impossible to do so, limitations must apply. However, these limitations cannot constitute a restriction to the freedom of movement.

Transposed to companies, three situations can occur, as noted by the European Commission[83]: Transfer of assets from the head office to a PE on other Member State, vice-versa or transfers between PE's in different Member States.

However, in all these situations, taxpayers cannot be subject to earlier of heavier taxation that non-departing residents, as the ECJ ruled in *Lasteyrie du Saillant*[84].

Notwithstanding, the departed State does not have to give up its taxing powers, otherwise all corporations would be moving from one Member State to another Member State throughout Europe! In fact, the Member State can define which amount it wants to tax, but has to grant a deferral of taxation. This deferral can be accompanied by the obligation to keep its TA informed. It is also adequate to grant the taxpayer the permission to waive its right to deferral and pay all its due taxes on his way out.

If the deferral is chosen, one might wonder if there is potential for double taxation. The answer would be "No", as the Member State to which the asset is transferred must accept either its fair market value or book value as the tax basis for future taxation. This step up of values would prevent the double taxation and would cancel in some way the benefit of immigrating for tax purposes only. If no step up is granted, then the realised gains should be split up between the Departure and immigration Member States. The emigration Member State can use the Administrative Cooperation Directive in order to obtain information on the realisation.

Moreover, one must further note that deferral is not a problem since the Recovery Assistance Directive is a proportionate means to secure taxation. Nevertheless, the ECJ

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[83] See Communication form the Commission to the Council, the European Parliament and the Economic and Social Committee on Exit taxation and the need for co-ordination of Member Sates' tax policies (Com (2006) 825 final), p. 6.

[84] Case C- 9/02, available at www.curia.eu

has accepted, as least once in *National Grind Indus*[85], the need to secure payment as a justification for exit taxation.

The ECJ has dealt extensively with exit taxation. The conclusions of the other major cases – in our opinion – not yet mentioned, are listed hereunder.

The freedom of establishment neither does allow Member States to forbid corporations from leaving its territory nor grants a corporation the right to transfer its seat to other Member State while continuing incorporated in a different Member State, as ruled in *Daily Mail*[86]. Sense is the keyword on this matter.

If the Member State can liquidate the company after the exit of its territory, it can also tax it at that moment, as concluded in *Überseering*[87]. This conclusion, despite being accurate, as the liquidation of the company leads to a transfer of its assets and liabilities to its shareholders, seems quite strange. Especially when confronted with *Cartesio*[88], according to which the Departure State can only demand a company to waive its status as a company under its jurisdiction, but not to liquidate it, if the Immigration State transforms it as company under its laws.

Further, Member States of Departure can, in case of deferral, require interest and secure payment as ruled in *National Grind Indus*[89].

Exit taxation was also dealt with under CCCTB's article 31. Under this provision, if the company is immigrating outside the EU, immediate taxation should be possible. One might add that this would be even necessary, as the Administrative Cooperation and Recovery Assistance Directives are not into force outside the EU. If the company is immigrating within the EU, there would be a fictional PE for exit taxation purposes.

3.2. The Portuguese CIT system

The new Portuguese CIT system deals expressly with these topics. Article 54-A deals with cross-border use of losses, while articles 83 and 84 deal with exit taxation.

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[85] Case C- 371/10, available at www.curia.eu
[86] Case C- 81/87, available at www.curia.eu
[87] Case C- 208/00, available at www.curia.eu
[88] Case C-210/06, available at www.curia.eu
[89] Case C- 371/10, available at www.curia.eu

Article 54-A refers to the tax gains and losses of a PE located outside Portugal belonging to a Portuguese company. Despite the focus of the analysis being the treatment of tax losses, the same regime is applicable to tax gains. Accordingly, the Portuguese taxpayer can choose not to consider the losses in its taxable income considering that the following conditions are met: (i) that income was subject to a CIT of at least 60% of the 23% Portuguese tax rate, i. e., it was taxed at a minimum CIT rate of 14% and (ii) the PE is not located in a tax haven.

If chosen, this regime will have to be applicable for at least three years and must include all PE's within the same jurisdiction, according to paragraph (6).

According to paragraph (8), there will be no relief in this regime. In fact, no relief is needed as an exemption is given. Therefore, there is no income to give relief to, as it is not considered in the taxable income.

Note, however, that the Portuguese legislator was not oblivious of the effects of this regime on taxpayers. Accordingly, paragraphs (4) and (5) only allow for the application of this regime whenever the tax losses of the twelve previous tax years are used.

Moreover, if this regime, after chosen, cannot remain applicable, as the requirements are no longer met, the tax losses are not considered for the taxable income until surpassing the tax gains of the previous 12 years (after entering into this regime).

Article 83 refers to exit taxation. According to paragraph (1), the value to be considered when departing is the difference between the fair market value and the book value. The following alternatives on the way to pay its taxes when leaving are presented to the taxpayer: to pay all taxes immediately when exiting, to pay all taxes in the following tax year or to pay the taxes in installments. Note that both the second and third options lead to the need to pay a compensatory interest, as per paragraph (3). As laid out in article 83 (9), if the taxpayer is departing to outside the EU or the European Economic Area, immediate taxation occurs, if there are not any mechanisms serving the same purpose of the Administrative Cooperation and Recovery Assistance Directives.

Confronting these new regimes – cross-border use of losses and exit taxation – with the theoretical approaches explained above, as clarified by the ECJ, one must withdraw the conclusion that, nowadays, the Portuguese CIT system is complying with EU legislation

3.3. SUMMARY OF CONCLUSIONS: OPEN ECONOMY CONTEXT

In terms of open economy, as there is nowadays a full compliance with EU legislation, there are no recommendations to be made. In fact, the Portuguese legislator must be congratulated for this achievement. The exemption regime applicable to branches will boost competition, and the changes in exit taxation regime will prevent another action for infringement to be filed against Portugal.

4. TAX POLICY RECOMMENDATIONS: WHICH TAX LOSS LIMITATIONS FOR PORTUGAL?

Based on the analysis carried out throughout this study, despite the Portuguese CIT reform having been able to solve many CIT issues, there are areas where it could have gone further. With this in mind, this study believes that these major tax policy recommendations can be given, considering the treatment of tax losses in both closed and open economies context:

The rules concerning the year limitation should be revised, in order for a limited carryback of two years to be introduced. This would enable Small and Medium enterprises, the majority of Portuguese enterprises, to be compensated by their losses after liquidation. In fact, ending on such a positive note, might contribute to allow them to pay other required taxes.

Moreover, as limited carryforward is the best choice due to budgetary constraints and the need to predict revenue, it should be complemented by an interest given to the taxpayer, in order to compensate it from the expiration of unused losses. This interest should be calculated according to the concept of time value of money and, therefore, should be adjusted by using a standard rate monitored by the Bank of Portugal. This approach should come into place once there is a relaxation of current budgetary constraints.

In Portugal, the entity limitation is well balanced with the mentioned exceptions – group taxation and corporate reorganisations –, which are the same, despite varying in certain aspects, throughout the world. After the reform, the Portuguese CIT system and its treatment of the entity limitation of tax losses is easy enough on the economic operators.

The character limitation is required from a tax policy perspective. Although, the formal divide is understandable, it is maintained mainly for historical reasons. As such, if the outcome may be virtually the same between a formal and a practical divide, there is absolutely no need to change the way the character limitation on tax losses has been dealt until now under Portuguese CIT law. Further, the European consensus, as can be seen in CCCTB, has been not to formalize this limitation.

The characteristics of the CIT system, when it comes to loss limitations, within a closed economy context, dictate its approach to risk-taking, as prescribed in the Government's tax policy. Further, the degree of risk-taking carried out by each taxpayer depends on its specific profile and willingness to adapt to the CIT loss limitations rules.

Based on the closed analysis undertaken, this study believes that the CIT reform may be beneficial to enhance competition and contribute to attract foreign investment. Nevertheless, the degree of corporate risk-taking may still be increased by introducing further adjustments to those rules. As mentioned previously, our strongest recommendation is to widen the carryforward period, couple it with an interest and, as soon as possible, introduce a limited carryback mechanism. With these alterations, the degree of corporate risk-taking may potentially rise.

In terms of open economy, as there is nowadays a full compliance with EU legislation, there are not recommendations to be made. In fact, the Portuguese legislator must be congratulated for this achievement. The exemption regime applicable to branches will be beneficial to enhance competition, and the changes in the exit taxation regime will prevent another action for infringement being filed against Portugal.

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APPENDIX 1

CITATION RULES

The citation rules used throughout this study can be summarized as follows:

- The authors' names are always in SMALL CAPS.

- While in the footnotes the authors' names are referred in the proper order (e.g. MIGUEL CORREIA, *Taxation of Corporate Groups…*), in the bibliography first appears the surname and then the name (e.g. CORREIA, MIGUEL, *Taxation of Corporate Groups…*).

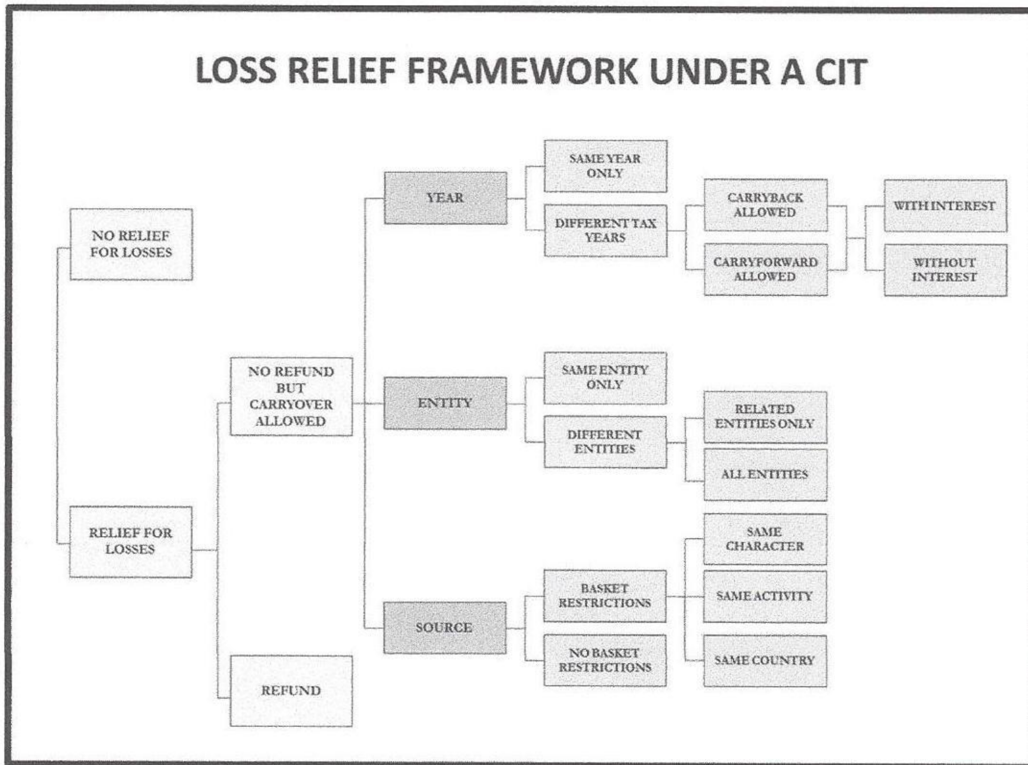
- Whenever a book is first cited, a full citation is given. After that, only the authors' names will be cited (e.g. "MIGUEL CORREIA, *ob. cit.* p. 11."). Whenever there are sequential footnotes referring to the same author and book *Ibid.* or *Ibidem* will be used.

- Page is always referred to as "p." and, in case of more pages to be read, "p. 11 *et seq*." will appear in the footnote.

- "See" is used in order to invite the reader to check the bibliographic source and confront it with the opinion given.

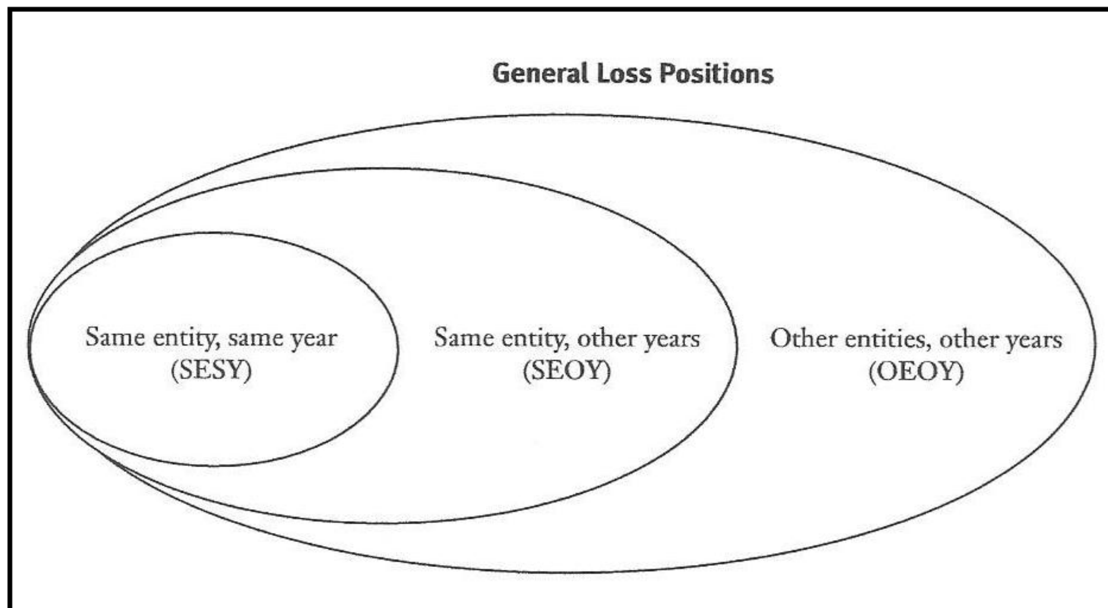
APPENDIX 2

FIGURE 1



Source: CORREIA, MIGUEL, *Taxation of Corporate Groups* (Kluwer Law International, 2013), p. 246

FIGURE 2



Source: DONNELLY, MAUREEN & ALLISTER YOUNG, *Policy Options for Tax Loss Treatment: How Does Canada Compare?*, 50 Canadian Tax Journal 429 (2002), p. 439