CROSS-BORDER FINANCING LACKS ACROSS-THE-BOARD APPROVAL

A recent European Court of Justice (ECJ) decision relating to cross-border financing of subsidiary businesses within the EU may require tax laws in many member states to be rewritten. In the meantime, companies should examine whether they can make a claim against 'unfair' tax laws.

The German *Lankhorst-Hohorst* case, in effect, ruled that tax laws which discriminate against companies from other EU member states are in violation of Article 43. Typically, the tax laws in question relate to "thin capitalisation" or "hidden equity". Accountancy firm Mazars explains that many member states have either of the following:

- Tax laws that put a limit on the amount of loan funding a subsidiary from another country can provide for its subsidiary so as to limit the outflow of tax-deductible interest payments.
- Laws whereby dividends from foreign subsidiaries to domestic parents are taxed.

Clearly, these rules typically don't apply to such payments where both the subsidiary and the parent are domestic companies.

But *Lankhorst* has now ruled that such tax laws discriminate against non-domestic companies within the EU. Member states may now rewrite their tax laws; whether they can do so without penalising their own domestic businesses or suffering drains on their national treasuries remains to be seen.

In this particular case, a Dutch parent advanced a loan to a German subsidiary, Lankhorst-Hohorst GmbH, but the German tax authorities claimed that, far from being a tax-deductible expense, it was actually a covert distribution and therefore subject to corporation tax on the interest payments to the parent.

The case went to the ECJ to decide whether the tax laws violated Article 43 which says, "… restrictions on the freedom of establishment of nationals of a member state in the territory of another member state shall be prohibited. Such prohibition shall also apply to restrictions on the setting up of… subsidiaries…"

While the British government (and the German and Danish governments, along with the European Commission itself) argued before the ECJ that such laws were needed to fight tax evasion through "thin" or "hidden equity" capitalisation, the court said it was already clear that the impact on tax revenues could not justify a measure that was contrary to Article 43.

A rock and a hard place

Mazars says that member state governments now have a number of choices:

- They can abolish the rules that discriminate against foreign companies, but this will impact on national treasuries.
- Tax laws can be changed so as to no longer favour domestic companies. This would raise additional revenue but be strongly resisted by domestic businesses.
- Tax laws could be redrafted so that domestic and other EU companies are treated equally, in a way that may be tax-neutral as far as overall revenues are concerned but would certainly still see 'winners and losers'.

More to the point, Mazars believes that companies should look carefully at how tax laws in EU member states may have affected them and start investigating whether they would have a claim against any such unfair tax laws. They should act without hesitation to protect their position and prevent being time-barred in any claim.

Aside from the instances mentioned above, where foreign subsidiary dividends are taxed and the different treatment of loan interest between parents and subsidiaries exists, the firm also highlights the following:

- Tax laws whereby losses of foreign subsidiaries may not be allowable, but similar losses by domestic subsidiaries are.
- Tax credits that may be available to domestic, but not foreign, parent companies.

Level playing field

Mazars explains that the question is becoming more pressing. "This is one of a series of ECJ judgments which indicate that the courts are imposing a level playing field, regardless of the cost to national treasuries." It suggests that a particularly radical development may be the introduction of a common tax system throughout the EU so as not to fall foul of Article 43.

Law firm Linklaters says that some 85 direct tax cases have been heard by the ECJ since the mid 1980s and all but a handful have been won by the taxpayer.

Accountancy firm Grant Thornton reports that the sums involved in Lankhorst alone could cost national treasuries up to £5bn.

Simon Whitehead at law firm Landwell adds that the *Oce van der Grinten* case could rule that withholding tax on dividends is also illegal.

Recently, Marks & Spencer lost a case against the special commissioners of the Inland Revenue over the question of its ability to offset overseas losses against UK profits. It invoked the same Article 43 arguments; hence, a number of commentators now believe the retailer would have more success if its case were to go to the ECJ (see *Financial Director* tax briefing, February 2003).

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- **Mazars can be found at www.mazars.co.uk**
- **The judgment is available at www.europa.eu.int/eur-lex/en/**