X AB v. Skatteverket. Court of Justice (comments by Maarten de Wilde)

On 10 June 2015, the Court of Justice of the European Union ('CJ') delivered its judgment in X AB v. Skatteverket (C-686/13). The CJ held the non-deductibility for Swedish corporate tax purposes of realised foreign exchange losses on shareholdings eligible for relief under the Swedish participation exemption regime compatible with the fundamental freedoms. The case concerned a Swedish company that held a 45% shareholding in a UK subsidiary company whose shares were issued in US dollars. Due to a devaluation of the US dollar relative to the Swedish krona, the Swedish shareholder company would be confronted with a foreign exchange loss upon a disposal of its UK shareholding. Such a loss, however, would not be tax-deductible under the applicable Swedish tax rules. The CJ held such a treatment not to infringe the freedom of establishment, amongst others, because the non-deductibility would have been in place irrespective of whether the shareholding investment involved had been made in a Swedish company or in a company in another EU Member State.

(…)

Comment

Context; general remarks

The CJ ruled the Swedish tax legislation concerning the non-deductibility of foreign exchange losses realised on shareholdings held for business purposes compatible with the freedom of establishment. The CJ essentially followed the Opinion of Advocate General Kokott of 22 January 2015. The case involved a Swedish resident corporate taxpayer, X AB, that set-up a subsidiary company in the UK, Y Ltd, whose shares were issued in US dollars. At the relevant time, X AB held a shareholding interest in Y Ltd of around 45% in the form of capital and voting rights. X AB wished to cease its investment operations in the UK and planned to dispose of its shareholding in its UK subsidiary company. Such a shareholding disposal, however, would lead to the realisation of a foreign exchange loss. X AB had contributed equity capital to Y Ltd in US dollars, in cash, and the US dollar had since devaluated relative to the Swedish krona – the currency in which X AB kept its tax bookkeeping. Notably, it is unknown from the facts of the case whether such a currency exchange loss would also appear economically. X AB intended to deduct any foreign exchange losses realised from its taxable base in Sweden. The company, however, was effectively confronted with a cost deduction limitation in the Swedish tax system at this point. Under the Swedish participation exemption regime, any shareholding proceeds, both profits and losses, foreign exchange results included, are exempt from the taxable base. Accordingly, the applicable Swedish tax rules would not allow X AB to deduct any foreign exchange losses realised upon a disposal of its shareholding in Y Ltd.

Non-deductibility of currency losses upon shareholding disposals in line with EU law?

X AB considered such a non-deductibility of foreign exchange losses to infringe EU law for rendering cross-border economic activity effectively less attractive than equivalent domestic activity. It requested the Swedish Revenue Law Commission to confirm this by means of a ruling. The Law Commission, however, did not, as it considered the Swedish exemption regime to operate in accordance with EU law for, in principle, excluding both profits and losses from the tax base calculation. X AB then brought the matter before the Swedish Supreme Administrative Court who requested the CJ for a preliminary ruling on whether the non-deductibility under the Swedish participation exemption regime infringes EU fundamental freedoms.

CJ held freedom of establishment applicable

The CJ first assessed which freedom applied. The Court concluded the freedom of establishment to be applicable. Adhering to settled case law, the CJ resorted to examining the facts of the case for this purpose. The CJ considered the object and purpose of the Swedish participation exemption regime of little assistance in this regard because of the regime's general application. The Swedish participation exemption applies to shareholdings held for business purposes. No minimum shareholding volume requirement applies if the shares are held in unlisted companies. Shareholdings in listed companies are eligible if they meet a threshold of at least 10% of the shares or voting rights. The CJ noted that X AB held a 45% shareholding in Y Ltd. It observed that a shareholding at this level, in principle, confers the shareholder a definite influence on the company's affairs. The CJ, therefore, qualified X AB's shareholding investment in Y Ltd as an act of establishment and held the freedom of establishment applicable. Of no relevance was the fact that the shares of the subsidiary company were issued in US dollars. Notably, as the CJ observed, the rules at issue to be of a generic nature, the freedom of capital would have applied had the case involved a shareholding in a subsidiary company in a third country.

CJ adopted legal-formal comparison and concluded restriction absent
The CJ proceeded its analysis and assessed whether the Swedish tax rules restrict the freedom of establishment. It held that these did not, as the non-deductibility of currency losses on shareholding disposals in cross-border scenarios is no different from that in purely domestic scenarios. Such foreign exchange losses realised are non-deductible, irrespective of whether the shareholding investment involved was made in a Swedish company or in a company in another EU Member State. According to the CJ, from that it follows that cross-border situations are not treated less favourably vis-à-vis purely domestic situations. To arrive at its observed parity in both cross-border and domestic scenarios the CJ adopted a legal-formal approach. It held that there is no difference in treatment between Swedish corporate taxpayers with domestic subsidiaries whose shares were issued in a foreign currency and Swedish corporate taxpayers with foreign subsidiaries whose shares were issued in a foreign currency. Indeed, from a legal perspective parity exists. Such foreign exchange losses are non-deductible in both cases.

Why no substantive comparison…
One may ask however whether such a parity, as observed by the CJ, is actually present in the investor's home State; effectively, in real terms in that is. How many would the actual number of purely domestic situations be of Swedish parent companies having Swedish subsidiary companies carrying on business activities in Sweden whose shares were issued in a currency other than the krona? Relative to the number of cross-border situations involving Swedish taxpayers, parent companies, having cross-border shareholding investments in non-Swedish subsidiary companies, that is? If the former would be significantly lower than the latter any non-deductibility of real foreign exchange losses would particularly affect cross-border investment. An outcome perhaps that may not be so unlikely. One may, therefore, question why the CJ did not resort to adopting a more substantive approach in its comparability assessment. There are examples of CJ cases available, although admittedly not corporate tax cases, in which the Court adopt such a more substantive approach towards comparing cross-border and domestic situations. In *De Coster* (ECJ 29 November 2001, C-17/00) and *Hervis* (C-385/15 P 1) for instance, the CJ assessed whether the national laws at issue differentiated between cross-border and domestic situations effectively, i.e., regardless of whether parity legal-formally exists.

… to conclude the presence of a restriction?
Under such a real terms comparison, one may quite well arrive at subsequently observing the presence of a real terms restriction; that is, to the extent that any exposure to exchange risks would be actually there economically – unfortunately, we do not know as the facts of the case do not tell whether a foreign exchange loss on aforementioned shareholding disposal would not only be realised for tax calculation purposes but also be suffered economically. Presuming this to be the case, any non-deduction of an actual currency loss, or any non-taxation of an actual currency profit for that matter, has as a consequence that the statutory tax rate and effective tax rate would diverge. A loss would produce an effective tax burden increase, a profit a decrease. Exposure to macro-economic currency exchange risks cannot be influenced at the micro level of an individual firm. Certainly, these risks can be hedged, for a price; that would be a business decision. However, the issue here is not about currency risk exposure or its mitigation through a hedging arrangement, it is about the implications of a non-recognition of exchange losses for corporate tax purposes. Any non-deductibility or non-taxation of economically realised foreign exchange results has as a consequence that the effective tax burden would include a component of speculation. The same, notably, is true from the side of revenue, although in reverse. That produces a tax induced exposure to currency exchange risks on top of any exposure to such risks already present in business environments with different currencies. And as such business environments predominantly are cross-border environments such an exposure produces market distortions that result from the acts of a single Member State; that is, a restriction.

Quantifying the tax induced distortion
Such tax induced market restrictions may even be quantified. In practice, risk-averse economic operators protect themselves against macro-economic currency exchange risks by engaging in hedging arrangements shifting the risks incurred to third-party financial institutions in return for remuneration. The tax induced market restriction may be appraised in a way similar to the manner in which deferred tax assets and deferred tax liabilities are evaluated in tax accounting. It may be valued loosely by reference to the applicable tax percentage as multiplied with the remuneration that would have been payable under a hedge arrangement. It follows: excluding real foreign exchange results from taxation is simply not neutral. It hinders cross-border investment and thus impedes a proper functioning of the internal market.

CJ holds that even if tax rules were distortive no need exists for Member States to adapt these
Nonetheless, the CJ added that even if the non-deductibility of currency exchange losses would be likely to disadvantage cross-border investment over domestic investment the Member States still would not be required to adapt their tax rules so to ensure tax neutrality. The CJ considered such a disadvantage to constitute a disparity. It noted that the freedoms of movement do not require the Member States to adapt their tax systems in such a way to neutralise any market distortions that are caused by the interaction of the currently disparate Member States' tax systems. Similarly, the CJ added, the Member States cannot be held accountable for any distortions that are the consequence of the 'continued existence of a diversity of currencies within the EU'. In brief, the CJ did not require the Member States to tax account for any distortive effects of monetary disparities.

CJ places tax effects that result from monetary disparities outside the protection of the freedoms, but why?
The CJ accordingly placed any tax effects that result from monetary disparities outside the protection of the freedoms of movement. Cross-border economic operators are left to fend for themselves at this point. I found myself struggling a bit with the CJ's observation at this point, to be honest. Foreign exchange risks are the consequence of monetary disparities. Should one wish to resolve these one would need to proceed to a monetary harmonisation as, for instance, currently is the case in the Eurozone. The issue at hand, however, does not involve the distortive effects of foreign exchange risks due to monetary disparities. It concerns as said the distortive effects of exempting currency exchange results from taxation, i.e., the question as to whether a Member State should allow taxpayers a deduction when a foreign exchange risk materialises and produces a loss – or should be enabled to tax a foreign exchange profit for that matter. Member States exempting exchange results render cross-border investment less attractive. Such an impediment would be induced by the tax system of a single country. Such a system effectively only recognises the home State currency for tax base calculation purposes: 'Sure, you may invest abroad but any tax exposure to exchange risks is at your expense.' The internal market encompasses a right of free movement. Exempting exchange results from taxation does not seem to promote that. So why place the taxation of foreign exchange results outside the protection of the freedoms? I honestly would not know.

CJ considered X AB *to be different from Deutsche Shell…*
The CJ proceeded by noting that its observations on foreign exchange results and taxation cannot be called into question by its statements in *Deutsche Shell* (ECJ 28 February 2008, C-293/06). That case involved a German corporate resident taxpayer in the pre-Euro age that set up a permanent establishment in Italy. The German entity financed these activities with equity it contributed as Italian liras that it had exchanged from Deutschmarks for this purpose. Some time later, the company transferred its branch to an Italian subsidiary company. That transaction was recognised as a taxable event for German corporation tax purposes that triggered the realisation of a foreign exchange loss in consequence of the devaluation of the lira relative to the mark. The exchange loss, however, was not tax-deductible, an effect the CJ held incompatible with the freedom of establishment.

… because of the legal contexts to be different in these cases
The CJ observed that *X AB* differed from *Deutsche Shell* in that the German tax legislation would have included currency exchange results in the taxable base as a general rule, while as an exception to this rule, the CJ noted, such results would be exempt from taxation if a double convention so stipulated. That is not the case, the CJ held, under the Swedish tax system for that system exempts such results from the tax base as a general rule. Unlike Germany, the CJ noted, Sweden had chosen not to exercise its powers of taxation on currency exchange results. Germany had, but for double tax convention scenarios in which it surrendered its taxing rights at this point under the applicable treaty. That rendered the legal contexts in *Deutsche Shell* and *X AB* to differ, the CJ noted. In such circumstances, the CJ added, the free movements do not require a Member State to – asymmetrically – exercise its tax competences to permit a deduction for exchange losses whereas equivalent profits would be exempt from taxation.

But X AB *and* Deutsche Shell *ended at the same page, so why the different outcomes?*
To be honest, I have a hard time understanding the CJ's observations at this point. Sweden did not exercise its powers of taxation to currency exchange results, the CJ noted. Okay, but Germany also did not, as it surrendered these powers under the applicable tax treaty. Both countries subjected their corporate taxpayers to taxation although in the end, exempted foreign exchange results from the taxable base. Both *X AB* and *Deutsche Shell* ended at the same page, did they not? So why the different outcomes? Furthermore, the question arises whether the argument of exempting such results from taxation under the applicable rules should be of any argumentative

relevance in the first place. I would tend to answer that question in the negative as, analytically, I would consider the applicable rules involved, such as a tax deduction limitation that bites harder in cross-border environments, to constitute the object of EU law assessment rather than an argument in EU law reasoning. I would say that the application of the tax rules constituted the problem rather than a solution for holding an EU law infringement absent. Otherwise, the applicable tax rule would escape EU law coverage. If so – and I admit to be generalising now – one would end up where one started at the point in time just before the CJ rendered its first rulings on direct tax cases in the mid-1980s: deeming direct tax cases to fall outside the ambit of the free movements.

Taxation or no taxation of foreign exchange losses, Member States are free to decide

Nevertheless, under EU law as it currently stands, things boil down to the following. If a Member State wishes to tax account for foreign exchange results under domestic rules, *Deutsche Shell* applies. Exchange losses would then need to be tax-deductible, i.e., irrespective of any double tax convention implications stipulating otherwise. If that Member State does not wish to tax account for foreign exchange results under domestic rules, *X AB* applies. Then, losses do not have to be deductible. Member States hence are free to decide, regardless of the implications of such a decision in terms of effective tax burden imposts in cross-border scenarios. If a Member State decides to exempt foreign exchange results from taxation any effects fall outside the ambit of primary EU law. I doubt whether that adheres to the spirit of the internal market.

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