IFA Congress 2022 Cancun

Subject 1: Sharing and shifting of osses - the new profit shifting?

General Reporter: Professor René Matteotti

Summary of the outline to IFA Branch Reporters

A. Reasons for Research

The reasons why we are looking at the topic of losses for the Cancun Congress is to raise awareness about possible commoditization of losses in the sense of particular use or trade in claims on a treasury due to entitlement of loss compensation. In an international context awareness is raised over the ways in which taxpayers via such commoditization of losses could have access to other countries' treasuries in ways that they are not meant to be and will lead to the funding of the interests of population whose treasuries are not those. Thus, the underlying question on which this report will try to create awareness is to what extent a country as a result of claims for loss compensation may be expected to relinquish control over its fiscal power, particularly in circumstances where there are fiscal, legal and other relevant differences among countries and countries (like in the case of the COVID-19 crisis) are largely using their present resources and anticipating the ones that they will have had in the future by allowing loss claims to be available indefinitely. Everything that comes after in this report are pathways or examples by which this indirect sharing of countries' treasuries not in the interest of the population whose treasuries they are comes about. Consequently, the purpose of this paper is not to comprehensively analyse the world this way but to illuminate on the ways in which tax systems' apparently benign characteristics may result in or may be used to share fiscal resources, which is unintended. This is particularly important at this moment because countries' resources are being increasingly deployed because of the demands imposed by the COVID crisis.

The countries' concern about shifting of losses may also lead to overreactions by denying loss compensations in cross-border situations where the loss compensation claimed by the taxpayer would be legitimate from an economic perspective. Should a country have specific loss-deduction provisions in place or limit the loss deduction by applying a GAAR, the IFA Branch Reporters are also asked to explore whether the application of these domestic statutory rules or a GAAR also limit the compensation of losses in situations where such a compensation would be justified from an economic perspective.

This summary of the outline shall inform the IFA Branches about the main topics to be covered in the Branch Reports in order to enable them to recruit the suitable national reporter.

The Branch Reports should be prepared based on the Directives that will be provided to the Branch Reporters after the Permanent Scientific Committee has approved them. This should occur in February 2021. More details on that will follow shortly.

The General Reporter is Professor René Matteotti of the University of Zurich. If Branch Reporters wish to contact him on any issues arising out of this Summary, or in the preparation of the Branch Reports, they are invited to do so by email at rene.matteotti@rwi.uzh.ch.

B. Language and Length

Although IFA rules allow the Branch Reports to be submitted in English, French, or German, it is clear that Reports in English will reach a much larger audience, since Reports in French or German will not be translated. Also, if a Report is submitted in either French or German, the Reporter should provide summaries/conclusions in English. Reports in other languages will not be accepted.

The maximum size of a Report is 10,000 words (including any tables, footnotes, and bibliographies). This limit is not open to extension.

C. Scope and aim of this Research for the 2022 IFA Congress in Cancun

All Branch Reports and Summaries must be submitted to the General Secretariat of IFA by October 15, 2021. It would be appreciated if draft Reports (or at least outlines) could be sent to the General Reporter by the end of July 2021.

D. Structure of the Branch Reports

The Branch Reports will consist of the following five Chapters

- **Chapter 1: Genereal Aspects of Tax Losses:** This chapter will explore the types of countries' tax policies for domestic losses such as timing aspects on the set-off of losses, losses carry-forward, losses carry-back, losses after the end of a business, group loss compensations, the transfer of losses in reorganization schemes, as well as the the role of GAARs and/or SAARs in the context of losses. The Branch Reporters will also be asked to analyze the domestic loss allocation rules of PEs as well as the rules on the recognition of losses from foreign subsidiaries and from the sale of shares in foreign subsidiaries. Thereby, the Branch Reporters should also analyze how these domestic rules interact with Double Tax Conventions (see Articles 5, 7 and 13 of the Models) concluded by the country covered by the Branch Report.

- **Chapter 2: Utilisation of Losses for Aggressive Tax Planning:** This chapter will be along with Chapter 3 the core of the Branch Report and describe the schemes concerning tax losses that have been encountered in the country which is covered by the Branch Report. The focus will be at schemes aiming at shifting losses to related or unrelated parties, circumventing restrictions on the carry-over of losses, circumventing rules on the recognition or treatment of losses, creating artificial losses, and claiming multiple deductions for the same loss. The Branch Reportes are in particular asked to look at financial instruments, corporate reorganizations and transfer pricing since these are the tools commonly used to shift losses.

- **Chapter 3: Impacts on BEPS on the Treatment of Losses:** The debate and possible solutions around the issues arising from base erosion and profit shifting typically focus on profits. However, it can be questioned how also the shift of losses can lead to base erosion. Taking into consideration possible schemes leading at the shifting of losses described in chapter 2 which are relevant in a cross-border context, this chapter aims at looking development following the BEPS project and it includes examples of domestic legislations that have been implementing BEPS recommendations in this area.

In particular, the Branch Reporters are asked to examine how multiple use of of the same loss is achieved through hybrid mismatches (Action 2 BEPS) and whether there are rules in place to tackle the multiple use of the same loss.

We are also interested to see how CFC losses are treated under the domestic CFC legislation (Action 3 BEPS).

With respect to interest deduction limitation rules (Action 4 BEPS), the Branch Reporters are expected to explore whether the domestic measures adopted pursuant to Action 4 BEPS still allow the shifting of losses leading to base erosion.

Losses can also be created through the incorrect use of Transfer Princing (TP) principles. BEPS Action 8-10 look more at substance, allocating to the real transaction. The actions have tightened up what can be allocated in TP by looking more at the substance than the form of the contract. What do these clarifications in BEPS Action 8-10 mean with regard to the allocation of losses? However, as also recognised in the final report of BEPS Action 8-10, associated and independent enterprises can indeed sustain genuine losses which can be due to heavy start-up costs, unfavorable economic conditions, inefficiencies or other legitimate business reasons. Business strategies might also vary and justifies such losses. How do the tax administrations deal with losses that are justified from an economic point of view in times there is a desperate need of revenue in order to cope with the economic consequences of the COVID-19-Pandemic crisis?

BEPS Action 12 provides recommendations for the design of rules to require taxpayers and advisors to disclose aggressive tax planning arrangements. Among the specific hallmarks referred into BEPS Action 12, there is a specific one dealing with losses. A loss schemes hallmark aims at capturing loss creation schemes which are designed to provide all or some of the individual participants with losses to reduce their income tax or capital gains tax liabilities or to generate a repayment. The Branch Reportes are asked to report whether the domestic disclosure rules comprise specific hallmarks involving loss transactions.

Differently, under BEPS Action 13, all large multinational enterprises (MNEs) are required to prepare a country-by-country (CbC) report with aggregate data on the global allocation of income, profit, taxes paid and economic activity among tax jurisdictions in which it operates.

Some of the schemes that have been outlined in the previous chapter might be relevant also from a cross-border perspective. Thus, it can be questioned where they also represent a form of treaty abuse and whether it would be the possible to apply a Principal Purpose Test (BEPS Action 6).

- **Chapter 4: Digitalized economy: losses under the OECD Pillar 1 and Pillar 2 proposals:** The two OECD proposals in relation to the digitalized economy (so-called Pillar 1 and Pillar 2 proposals) also address losses. The allocation of losses is specifically addressed under Pillar 1, while Pillar 2 focuses on the treatment of those losses. As these pillars are still under discussion, it is not yet possible to fully foresee whether there might be abusive practices. The Branch Reporters will be asked to explore whether the interplay of domestic loss allocation rules and the OECD Pillar 1 and Pillar 2 proposals could lead into a unjustified shifting of losses.

- **Chapter 5: Impact of COVID-19 on the treatment of losses:** Because of the Covid-19 crisis, corporate tax revenues may also remain depressed for some time into the future as any losses generated in 2020 will generally be available to be carried forward and applied against future income. The Branch Reporters will be asked to look into the following issues:
    - Deferral of tax obligations: Shift of income from the country with no deferral to the branch located in a country where there is a deferral. However, this does not necessarily consist in shifting of losses.
    - Changes to loss-offset provisions: Some countries have introduced or have announced measures allowing loss carry-back for the 2020 tax year, which will allow taxpayers to carry back their 2020 tax losses against profits earned in previous fiscal years (the Czech Republic, Norway, Poland, and the United States). Other countries are increasing the loss-carry forward period for losses incurred in 2020 (China, the Slovak Republic). Cash flow support could also be augmented by expanding loss-carry-back measures to target firms that are currently in a loss position. Expanding loss-carry-back measures, e.g., by extending time limits or increasing refund ceilings, could be particularly impactful due to the countercyclical effects of these measures. In addition, these measures have the advantage of targeting lossmaking firms that will typically not benefit from other tax measures such as rate reductions, deferrals or exemptions. For SMES it could be considered to allow losses to be offset against personal income of shareholders/directors to allow them to be used immediately. Loss-carry-forward measures will have a less immediate effect as the related tax benefits can only be realized if and when firms become profitable again. However, they could still have positive effects on investment decisions through their impact on expectations after the health crisis has passed. Extending cash flow support measures should nevertheless avoid storing up problems for the future, making it more difficult for taxpayers to return to normal if, for example, debts build up to unsustainable levels or deferred payments lead to severe cash flow problems at a later date. Does the change of provisions concerning losses enable new opportunities to shift losses? Which will be the influence on cross border allocation of losses/and anti-abuse rules? Indeed, wider is the system, wider the possibilities to abuse. What will be the impact if relaxation to current systems are adopted in some countries while not in other?

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