COMMISSION OF THE EUROPEAN COMMUNITIES

COM (90) 595 final
Brussels, 24 January 1991

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

Reproduced from Bulletin of the European Communities, Supplement 4/91, pages 55-65.

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

THE COUNCIL OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Economic Community, and in particular Article 100 thereof,

Having regard to the proposal from the Commission,

Having regard to the opinion of the European Parliament,

Having regard to the opinion of the Economic and Social Committee,

Whereas in a common market having the characteristics of an internal market, the activities of enterprises across Community borders should not be treated less favourably than activities limited to a single Member State, a requirement that is not currently met, since existing legislation often does not permit enterprises to take into account the losses incurred by their permanent establishments and subsidiaries situated in other Member States; whereas it is consequently necessary to introduce common rules covering all enterprises, whatever their legal form;

Whereas, in the case of permanent establishments, Member States should ensure that the enterprises of which they form an integral part are able to take account of their losses, either by allowing the results of such permanent establishments to be included in those of the enterprises and, at the same time, authorizing the latter to deduct the tax paid by the said establishments in the other Member States from any tax due in respect of their profits, or by authorizing the enterprise to deduct the losses of its permanent establishments from its own profits and taxing subsequent profits of the latter to the extent of the losses deducted; whereas the results of permanent establishments should be determined Member State by Member State;

Whereas in the case of subsidiaries, the latter method appears under the present circumstances to be the most appropriate means of allowing enterprises to offset the losses incurred with respect to activities across Community borders; whereas it is appropriate for the account taken by the parent enterprise of its subsidiaries' losses and profits to be determined separately for each subsidiary in proportion to the parent's holding therein; whereas, since a subsidiary is a legally independent entity, the enterprise which controls it should be free to decide whether or not to take into account its losses; whereas provision should be made to prevent the same losses from being taken into account twice by excluding the use of the method specified in this Directive in conjunction with an adjustment to the value of the holding;

Whereas, where the enterprise applies the method of deducting losses with reintegration of subsequent profits, the results of permanent establishments and subsidiaries may without any difficulty be determined according to the law of the Member State in which they are situated;

Whereas, in order to preclude unjustified advantages for enterprises and to safeguard the Member States' tax revenues, Member States must be allowed, in certain circumstances, to reincorporate automatically losses previously deducted; whereas, in addition, Member States should be free to apply provisions designed to prevent tax evasion and abuse;

Whereas it is appropriate to allow Member States the option of maintaining or introducing other means of taking into account subsidiaries' losses alongside the common method defined in this Directive;

Whereas, with a view to improving the worldwide competitiveness of Community enterprises, it appears appropriate to extend the arrangements laid down by this Directive to permanent establishments and subsidiaries situated in non-member countries; whereas Member States should be free to determine the conditions and scope of any such extension,

HAS ADOPTED THIS DIRECTIVE:

Article 1

Member States shall adopt, in accordance with the provisions of this Directive, arrangements enabling their enterprises to take account of the losses incurred by permanent establishments or subsidiaries situated in other Member States.

TITLE I

General provisions

Article 2

For the purposes of this Directive:

— *'enterprise of a Member State'* means any enterprise which, under the tax legislation of a Member State, is considered to be resident for tax purposes in that State,

— *'permanent establishment'* means any fixed place of business through which an enterprise of a Member State carries on all or part of its activities,

— *'subsidiary'* means any company in the capital of which an enterprise of a Member State has a minimum holding of 75 %, giving it a majority of voting rights. Member States may, however, stipulate a lower minimum holding.

Article 3

In order to fall within the provisions of this Directive, the enterprises, permanent establishments, and subsidiaries referred to in Article 2 must be subject to, without being exempt from, one of the following taxes:

(a) in Belgium:

— impôt des personnes physiques/personenbelasting,

— impôt des sociétés/vennootschapsbelasting,

— impôt des non-résidents/belasting der niet-verblijfhouders;

(b) in Denmark:

— selskabsskat,

— indkomstskat til staten;

(c) in Germany:

— Einkommensteuer,

— Körperschaftsteuer;

(d) in Greece:

— φόρος εισοδήματος φζσικών προσώπων,

— φόρος εισοδήματος νομικών προσώπων,

(e) in Spain:

— impuesto sobre la renta de las personas físicas,

— impuesto sobre sociedades;

(f) in France:

— impôt sur le revenu,

— impôt sur les sociétés;

(g) in Ireland:

— income tax,

— corporation tax;

(h) in Italy:

— imposta sul reddito delle persone fisiche,

— imposta sul reddito delle persone giuridiche;

(i) in Luxembourg:

— impôt sur le revenu des personnes,

— impôt sur le revenu des collectivités;

(j) in the Netherlands:

— inkomstenbelasting,

— vennootschapsbelasting;

(k) in Portugal:

— imposto sobre o rendimento das pessoas singulares,

— imposto sobre o rendimento das pessoas collectivas;

(l) in the United Kingdom:

— income tax,

— corporation tax,

or any other tax which may be considered a substitute for one of these taxes.

Article 4

Member States may extend the application of this Directive, under conditions which they shall lay down, to all or some of their enterprises' permanent establishments and subsidiaries situated outside the Community. However, these conditions may not be more favourable than those applicable to permanent establishments and subsidiaries situated in the other Member States.

TITLE II

Provisions relating to permanent establishments

Article 5

Member States shall make provision for their enterprises to take account of the losses incurred by permanent establishments situated in another Member State either by means of the credit method defined in Article 6, or by means of the method of deducting losses and reincorporating subsequent profits, as defined in Article 7.

Application of the credit method shall be obligatory for enterprises in Member States that have chosen it; application of the method of deducting losses and reincorporating subsequent profits is a matter for each enterprise to decide.

Article 6

The credit method shalll consist of including in the enterprise's results for a given tax period the positive or negative results of all the enterprise's permanent establishments situated in another Member State, and where appropriate, crediting the tax paid by the latter against any tax which may be payable by the enterprise on the profits of such establishments.

Article 7

1. The method of deducting losses and reincorporating subsequent profits shall involve:

(a) the deduction from the enterprise's taxable profits for a given tax period of the loss incurred in the same tax period by the enterprise's permanent establishments situated in other Member States;

(b) the incorporation of subsequent profits of such permanent establishments into the enterprise's taxable income to the extent of the loss deducted pursuant to subparagraph (a).

2. The income of permanent establishments shall be determined Member State by Member State in accordance with the rules of the law of the Member State in which the permanent establishment is situated.

Article 8

Member States may make provision for losses which are deductible pursuant to Article 7 to be automatically reincorporated into the enterprise's taxable results in one of the following circumstances:

(a) where reincorporation has not occurred by the end of the fifth year following that during which the loss became deductible;

(b) where the permanent establishment has been sold, wound up or transformed into a subsidiary.

TITLE III

Provisions relating to subsidiaries

Article 9

1. Member States shall make provision for their enterprises to take account of the losses incurred by subsidiaries situated in another Member State by means of the method of deducting losses and reincorporating subsequent profits.

This method shall involve:

(a) the deduction from the enterprise's taxable profits for a given tax period of the loss incurred in the same tax period by the enterprise's subsidiaries situated in other Member States;

(b) the incorporation of subsequent profits of such subsidiaries into the enterprise's taxable income to the extent of the loss deducted pursuant to subparagraph (a).

2. The income of each subsidiary shall be determined in accordance with the rules of the law of the Member State in which it is situated, in proportion to the holding which the enterprise has in its capital. The level of holding to be applied in this respect shall be the lowest obtaining during the tax period in question.

Article 10

Member States may make provision for losses which are deductible pursuant to Article 9 to be automatically reincorporated into the enterprise's taxable income in one of the following circumstances:

(a) where reincorporation has not occurred by the end of the fifth year following that in which the loss became deductible;

(b) where the subsidiary is sold, wound up or transformed into a permanent establishment;

(c) where the enterprise's holding in the capital of the subsidiary has fallen below the minimum level laid down by the Member State in which the enterprise is situated.

Article 11

Application of the method defined in Article 9 shall be incompatible with any correction of the value of the holding of that enterprise in a subsidiary.

Article 12

The provisions of this Directive shall not prevent Member States from maintaining or introducing other methods of taking into account the losses of subsidiaries of its enterprises located in other Member States, including the consolidated profit method.

TITLE IV

Final provisions

Article 13

This Directive shall not preclude the application of provisions laid down by national law or under agreements to prevent tax evasion or abuse.

Article 14

1. Member States shall bring into force the laws, regulations and administrative provisions necessary to comply with this Directive before 1 January 1993. They shall immediately inform the Commission thereof.

When Member States adopt these measures, these shall contain a reference to this Directive or shall be accompanied by such reference at the time of their official publication. The procedure for such reference shall be adopted by Member States.

2. Member States shall ensure that the texts of the main provisions of national law which they adopt in the field covered by this Directive are communicated to the Commission, and, should the occasion arise, the texts of measures taken to extend the provisions of this Directive to permanent establishments and, subsidiaries of their enterprises located outside the Community.

Article 15

This Directive is addressed to the Member States.

ANNEX

Tax arrangements applicable to losses of subsidiaries and foreign permanent establishments

Member State	Resident subsidiary	Foreign permanent establishment	Foreign subsidiary
Belgium	—	— No tax treaty: deduction with reintegration following a certain order (Article 66 and following AR — CIR) — Tax treaties: exemption method — Deduction with reintegration where a treaty provides for exemption	—
Denmark	Consolidation (consolidated profit 100 % subsidiary)	— No tax treaty: taxation of worldwide income with tax credit — Tax treaties: taxation of worldwide income with either tax credit or exemption with progression, or exemption	Consolidation (consolidated profit 100 % subsidiary) Double taxation is in practice avoided in the same way as for foreign permanent establishments
Germany	Consolidation when the Organschaft system is applied (subsidiary under financial (51 % of votes) structural and economic control) at the option of the parent company	— No tax treaty: taxation of worldwide income with tax credit — Tax treaties: exemption method deduction of losses with reintegration where a treaty provides for exemption	—
Greece	—	— No tax treaty: in principle tax credit method except if the global result of all permanent establishments is negative (no deduction of losses in such cases) — Tax treaties: tax credit method	—
Spain	Consolidation (consolidated profit) 90 % subsidiary minimum	— No tax treaty: taxation of worldwide income with tax credit — Tax treaties: tax credit method	—
France	Consolidation if: 1. Consolidated profit (bénéfice consolidé) upon authorization by the tax authorities ([1]) 2. System of fiscal integration (régime d'intégration fiscale) 95 % subsidiary minimum	— Tax treaties: exemption method — Taxation of worldwide income in the framework of the 'bénéfice mondial' system upon authorization by the tax authorities ([1]) and irrespective of whether a treaty applies or not	Consolidation if: 1. Regime of 'bénéfice consolidé on authorization ([1]) 2. Deduction of losses of the first five years to the invested amount for investment in the EEC with automatic reincorporation once profits are carried and at the latest after 10 years (Article 39-80-B-CGI)
Ireland	Loss offsetting if: 1. A minimum participation of 75 % in a subsidiary or 2. Consortium	— No tax treaty: taxation of world wide income with tax credit — Tax treaties: tax credit method — If the foreign tax rate exceeds the Irish rate, a partial deduction is granted for the excess amount	—

([1]) In practice very limited application.

Member State	Resident subsidiary	Foreign permanent establishment	Foreign subsidiary
Italy	—	— No tax treaty: taxation of world wide income with tax credit — Tax treaties: tax credit method	—
Luxembourg	Tax consolidation when the Organschaft system is applied (subsidiary at 99 %) at the option of the parent enterprise and upon authorization by the Minister of Finance	— No tax treaty: taxation of world wide income with tax credit — Tax treaties: exemption method without deduction of losses	—
Netherlands	Tax consolidation when application of fiscal entity (fiscale eenheid) 99 % subsidiary. Under certain conditions losses which arise in the case of winding up a subsidiary that is part of a fiscal entity can be taken into account	No tax treaty: taxation of world wide income with tax credit Tax treaties: exemption method Deduction with reintegration in case of losses when a treaty provides for the exemption method	Under certain conditions, losses which arise in the case of winding up a subsidiary can be taken into account
Portugal	*Consolidation* (90 % subsidiary at the option of the parent enterprise)	— No tax treaty: taxation of world wide income — Tax treaties: taxation of worldwide income with tax credit	—
United Kingdom	Tax arrangements for losses if: 1. 75 % subsidiary minimum or 2. Consortium	— No tax treaty: taxation of world wide income with tax credit — Tax treaties: tax credit method	—

(¹) In practice very limited application.

Explanatory memorandum

General

Introduction

1. One of the obstacles which might seriously hamper the activities of enterprises in a common market having the same characteristics as an internal market is their inability to deduct from their profits the losses incurred by permanent establishments and subsidiaries situated in Member States other than the one in which the enterprise in question is resident for tax purposes.

In its communication to Parliament and the Council of 20 April 1990 concerning 'Guidelines on company taxation' (Doc. SEC(90) 601 final), the Commission stressed the need to find a common solution enabling this obstacle to the single European market to be removed.

Problems affecting permanent establishments

2. While the results of establishments situated within the country of the head office form an integral part of the enterprise's results, the mere fact that there is a frontier between a permanent establishment and its head office may result in the losses of the foreign permanent establishment not being deductible from the profits of the head office. The enterprise therefore pays an excessive amount of tax in relation to the total net result of its activity since taxation is based on the result achieved solely in the country in which the head office is situated.

3. This problem does not arise in Member States which take account of the results — positive or negative — of a foreign permanent establishment, thus avoiding double taxation, where profits are made, by crediting foreign tax to the domestic tax payable in respect of the permanent establishment (imputation or tax credit method). [1]

In contrast, those other Member States which exempt the profits of a foreign permanent establishment (exemption method) do not in principle take into account the losses incurred by such a permanent establishment. However, some of them do allow foreign losses to be deducted while also taxing subsequently any profits the permanent establishment makes by reincorporating them into the results of the head office to the extent of the amounts previously deducted.

4. It is the latter solution (reincorporation method) which the Commission has opted for in its proposal for a Council Regulation on the Statute for a European Company (Article 133). [2]

The Commission considers, however, that this solution should be available not solely to the European company but to all companies engaged in transfrontier activities through permanent establishments or subsidiaries, whatever their legal form.

The general application of arrangements for taking losses into account will also be of benefit to a new legal structure for transfrontier cooperation governed directly by Community law, i.e. the European economic interest grouping (EEIG). In practice, an EEIG might be regarded by the tax authorities as a permanent establishment of its members. In this case, the results of the EEIG will be calculated separately from the results determined at the level of its members.

In view of the auxiliary nature of an EEIG's activity, the risk that such determination of results in the country in which the EEIG is established will lead to losses is considerably greater than in the case of the other enterprises. The non-deductibility of such losses in the member's country of residence constitutes an obstacle to making use of this new Community instrument for the purposes of transfrontier cooperation.

Problems affecting subsidiaries

5. An enterprise may carry on its activity outside the territory of the Member State in which its head office is situated, either through the intermediary of a permanent establishment, or through that of a subsidiary, the latter having its own legal personality and coming under the law of the Member State in which it is established. Economically speaking, these two structures used to carry on an activity abroad are equivalent, and the choice between them should not

[1] See Annex, p. 58.

[2] Doc. COM(89) 268 Final — SYN 218 and SYN 279, 25 August 1989.

necessarily be influenced by tax considerations. However, the choice between them would not be neutral if the arrangements for deducting losses incurred by foreign subsidiaries were less favourable than those applicable to permanent establishments.

Equality of treatment between permanent establishments and subsidiaries is not, however, a generally accepted idea. Traditionally, company taxation is based on the legal concept of the independence of companies without consideration of the economic ties which may exist between them. In some Member States, this approach also determines the tax rules applicable to subsidiaries, not only on an international level but also domestically.

Annex 1 contains a summary of the rules applicable in the Member States at both these levels.

Possible solutions in the case of a permanent establishment

6. Given that a number of Member States [1] already apply the credit method to the results of foreign permanent establishments, it seems logical to adopt this method as one of the common solutions.

This method must still allow any negative result which may arise for all foreign permanent establishments combined to be deducted from the profits of the head office. Consequently, provisions imposing limits in this regard, such as those currently applied in Greece, cannot be maintained.

7. Another solution is to permit enterprises to deduct losses incurred by their permanent establishments situated abroad from the results of the head office and subsequently to tax the profits of such permanent establishments by reincorporating them into the results of the head office to the extent of amounts previously deducted ('method of deducting losses and reincorporating subsequent profits').

This method may, for example, be chosen by Member States in which the law does not provide for the credit method and which consequently exempt profits earned outside the country.

8. However, according to the particular characteristics of each of these two methods, certain arrangements must be made in order to safeguard the revenue interests of the country in which the enterprise is established and to prevent manipulation.

This is particularly true for the method of deduction and subsequent reincorporation since it would give the enterprise an unjustified advantage if it were possible to escape recovery of the tax not previously due because of reduced taxation. For this reason, Member States should be permitted to reincorporate automatically amounts previously deducted if reincorporation has still not occurred after five years or if the permanent establishment ceases to exist in that form.

9. At the same time, compulsory reincorporation allows for some flexibility in the choice of tax legislation to be applied for determining the results of foreign permanent establishments. Since the country in which the head office is situated is authorized subsequently to compensate for the deduction of losses by taxing the profits of the permanent establishment, there is no reason why both the losses and profits taken into account should not be those determined in accordance with the rules of the Member State in which the permanent establishment is situated.

10. Arrangements for taking into account the losses of foreign permanent establishments must be compulsory only in respect of permanent establishments situated within the Community. Of course, Member States remain free to extend the scope of the method they choose to cover all or some of the permanent establishments situated outside the Community, and to determine the conditions of such extension. Some of them, in particular those which apply the credit method as the basic arrangement, have already done so.

11. In the interests of the proper functioning of the reincorporation mechanism based on the deduction method it is desirable for there to be parallel harmonization of the rules enabling the losses of the permanent establishment to be carried forward to subsequent tax years in the country in which it is situated. It is thus important that the proposal for a Council Directive on the harmonization of the laws of the Member States relating to tax arrangements for the carry-over of losses of enterprises [2], presented by the Commission on 11 September 1984, be adopted alongside this proposal for a Directive.

Possible solutions in the case of a subsidiary

12. The first question to be decided is that of the basic approach: is it sufficient simply to extend

[1] See Annex, p. 58.
[2] OJ C 253, 20.9.1984, p. 5; and OJ C 170, 9.7.1985, p. 3.

beyond national frontiers the arrangements for taking into account the losses of domestic subsidiaries wherever they exist, or should common arrangements be established?

The former approach, i.e. extending the scope of national arrangements beyond the country's frontiers, at first sight offers the advantage that it affords strictly equal treatment to transfrontier activities and those carried on within the country. There are, however, two drawbacks. On the one hand, it would offer no solution to the three Member States whose domestic legislation makes no provision for taking the losses of domestic subsidiaries into account. On the other hand, given the major disparities which exist between the Member States' domestic arrangements, it would create new distortions between their enterprises engaged in transborder activities.

This approach, therefore, does not satisify at all the requirements of fiscal neutrality with respect to competitive conditions on the Community level. For this reason, it has been ruled out by the Commission.

The second approach, i.e. the establishment of common arrangements, does not have these drawbacks. On the contrary, it responds entirely to the necessity of fiscal neutrality.

13. Before moving on to discuss the choice of methods to be adopted for the purposes of the common arrangements, it is necessary to establish the minimum holding which an enterprise must have in a subsidiary before the relationship between the enterprise and the subsidiary can be considered equivalent to that between an enterprise and a permanent establishment.

The holding of a limited number of shares in another company tends to constitute a form of investment for a given enterprise. In order to justify the results, and particularly the losses, of that subsidiary being taken into account for tax purposes at the level of the enterprise heading the group, the latter should have a sufficient influence on the management of the subsidiary. This condition can be considered satisfied if the holding in the subsidiary's capital is greater than 50 %, thereby giving the enterprise heading the group a majority of voting rights.

If a closer parallelism is to be established between permanent establishment and subsidiary as regards their respective degree of economic integration with the head of the group, a threshold of 100 % might even be envisaged. However, whilst this would offer clear advantages in terms of simplicity, it would considerably limit the scope of the arrangements because the holding of the entire capital of a subsidiary is only possible in practice where new companies are formed.

In this respect, it must be stressed that even those Member States which apply a system of consolidation at national level do not, with the exception of Denmark, require a 100 % holding.

On the other hand, in order to avoid inverse distortions that work to the detriment of resident groups of undertakings, the conditions of common arrangements for taking foreign losses into account should not be too different from those applied at national level. In this regard, it is noteworthy that those Member States with a system of loss offsetting at the national level for subsidiaries require a holding of 75 % or more by the parent in its subsidiary.

A holding of 75 % would therefore appear to be appropriate for a common transborder system. It would ensure equal treatment among permanent establishments and subsidiaries and at the same time permit significant use of the common system.

14. As for the methods to be employed, the losses of a foreign subsidiary can, in principle, be taken into account in a similar manner to that described above for permanent establishments, the imputation method being similar to that of profit consolidation.

Nevertheless, the Commission considers that, in view of current national tax laws involving differences in both the tax base and tax rates, the application of this method would encounter considerable practical difficulties, and that it would be extremely difficult for the enterprise concerned to assess the usefulness of such a method. The fact that the French system of consolidation is seldom used is evidence of the latter difficulty.

As the internal market becomes more integrated, however, the Commission does not rule out future use of a common system of consolidation. It is with this prospect in mind, that the Commission will ask the Committee of experts responsible for studying the problems of business taxation to examine the broad range of questions related to the establishment of a common system of consolidation.

15. Consequently, the Commission proposes only the second method, which involves allowing the enterprise heading the group to deduct the losses incurred in a given tax period by its subsidiaries situated in other Member States from its taxable prof-

its for the same tax period, with any subsequent profits by these subsidiaries being reincorporated into the enterprise's taxable results to the extent of the loss previously deducted.

In order to safeguard the tax revenue interests of the Member State in which the enterprise is situated and to prevent manipulation, provision should be made, as in the case of permanent establishments, to allow Member States to reincorporate deducted losses automatically into the enterprise's taxable results if such reincorporation has not been carried out after five years.

16. The Commission has not deemed it appropriate to include at the Community level, another method of taking account of the losses incurred by subsidiaries, i.e. that of writing down the book value of the enterprise's holding. Making this method generally available comes up against the problem that taxable profits are not determined in all Member States in accordance with commercial accounting rules. For this reason, it would be virtually impossible to apply in Member States whose tax legislation lays down that profits for tax purposes are to be determined independently of commercial profits.

But even in those countries which do determine their enterprises' taxable profits in accordance with commercial accounting rules, the effect of the write-down method is limited to the present value of the holding. In cases in which the amount of the subsidiary's losses is greater than the present value of the holding in the enterprise's balance sheet, that portion of losses in excess of the present value may not be taken into account.

Moreover, reincorporation into the enterprise's profits of amounts previously deducted unter the write-down method gives rise to a number of problems. This is because the subjective scope of the Directive takes in all enterprises which, under the tax laws of a Member State, are considered to be resident in that State for tax purposes, whereas the Fourth Council Directive of 25 July 1978 on annual accounts [1], Article 35(1)(c)(dd) of which requires the lower value to be increased if the reasons for which the value adjustments were made have ceased to apply, applies only to limited companies. There would not be any requirement on the other forms of enterprise falling within the scope of this Directive to revalue the holding in their balance sheet. Even in the case of limited companies, the occurrence of subsequent profits in a subsidiary does not as such give rise to revaluation unless it reflects a continuous improvement in the subsidiary's productivity. In other words, the fact that a subsidiary makes a profit in a subsequent tax period does not necessarily result in an adjustment of the value of the holding in the parent enterprise's balance sheet.

17. Each enterprise will be free either to make use of the common method of taking into account the losses incurred by subsidiaries or to have the ordinary arrangements, i.e. separate taxation of subsidiaries, applied to it.

Moreover, there is nothing to prevent a Member State from maintaining or introducing another method of loss offsetting, such as the consolidation method, alongside either of the methods laid down by the Directive, provided it is understood that an enterprise may not combine the former with the common system.

Commentary on individual articles

Article 1

18. Member States will have to make it possible under their laws for their enterprises to take into account the losses they incur through ventures situated in other Member States, be they permanent establishments or subsidiaries.

It is not only limited companies which carry on transfrontier activities through permanent establishments or subsidiaries in other Member States, but also other forms of enterprise, including partnerships and one-man businesses. One of the main aims of this Directive is to establish the principle of equal treatment for all legal forms of enterprise.

Article 2

19. The purpose of this Article is to define three basic notions, i.e. 'enterprise of a Member State', 'permanent establishment' and 'subsidiary'.

- An enterprise is deemed to be situated in a Member State if it is resident there for tax purposes according to the law of the Member State in question, account being taken of the provisions of bilateral agreements.

[1] OJ L 222, 14.8.1978, p. 11.

• The definition of 'permanent establishment' is modelled on that of Article 5 of the OECD Model Convention.

• The notion of subsidiary is defined with reference to two criteria: a majority of voting rights to be held by an enterprise of a Member State, and its holding in the subsidiary's capital to stand at a minimum level. The combination of these two criteria is necessary because of the existence in several Member States of multiple voting shares and non-voting shares.

Although a Member State is free to fix a lower minimum holding, it must always respect the majority voting rights criterion.

Article 3

20. This Article lists the taxes to which the enterprise, permanent establishment or subsidiary must be liable in order to qualify for application of the Directive. These are either personal income tax or corporation tax, depending on the enterprise's legal form.

Article 4

21. It is left to the discretion of each Member State whether to widen the geographical scope of the arrangements laid down by the Directive to permanent establishments or subsidiaries situated outside the Community. Whereas all permanent establishments or subsidiaries situated in the Community must be covered, it is up to the Member States to determine the extent to which the arrangements should apply on a world scale.

However, the provisions applicable to permanent establishments or subsidiaries situated outside the Community may not be more favourable than those applied within the Community. The results of all permanent establishments are already taxed in the hands of the head office in those Member States which apply credit or world-wide profit arrangements.

Article 5

22. This Article lays down that Member States are required to apply to the losses of their enterprises' permanent establishments one of the two methods described in Articles 6 and 7, which are of equal status.

Article 6

23. Article 6 defines the credit method. It is important to note that this method involves taking into account, at the level of the enterprise's head office, both the positive and the negative results of its permanent establishments.

Article 7

24. Since the method of deducting losses and reincorporating subsequent profits gives the enterprise which applies it only a temporary cash advantage, it would seem justified to stipulate that the Member State in which the enterprise in question is resident for tax purposes must allow the losses of permanent establishments situated in other Member States to be deducted as they are shown on the permanent establishments' tax accounts, and should not recalculate them according to its own tax rules.

Should the Member State extend the scope of this method's application to permanent establishments situated outside the Community, it is free to lay down more strict rules stipulating, for example, that foreign results must be recalculated according to the domestic rules.

Article 8

25. This Article offers Member States the possibility of prescribing compulsory reincorporation of amounts previously deducted if the enterprise's foreign activity does not yield a profit within five years. This five-year time-limit applies separately to each tax period at the end of which losses have been deducted.

26. Another situation which may give rise to automatic reincorporation is where a permanent establishment is sold, wound up or transformed into a subsidiary; this is because such an operation takes the permanent establishment outside the scope of the method.

Article 9

27. The method laid down for taking a subsidiary's losses into account is identical to that used for permanent establishments as described in Article 7, except that the losses allowed as a deduction are

determined separately for each subsidiary, without any aggregation.

Article 10

28. As in the case of the method of deducting the losses of permanent establishments, the Directive authorizes Member States to provide in their laws for the automatic reincorporation of amounts previously deducted if reincorporation has not occured by the end of the fifth year following deduction of the loss. The same rule applies where the subsidiary is sold, would up or transformed into a permanent establishment.

Provision must also be made to cover one further situation. Since the Directive is applicable only if the enterprise's holding in the subsidiary reaches a minimum threshold, it is logical that amounts previously deducted should automatically be reincorporated if its holding falls below that threshold.

Article 13

29. Notwithstanding the fact that the present Directive does not provide the method of writing down the book value of the holding as a Community solution, Member States are free to include this method as an additional one into their internal legislation. In such a case, it shall, however, be avoided that an enterprise applies at the same time both the method provided by this Directive and the method of writing down the book value, because otherwise the same loss would be taken into account twice.