Euro Tax Flash from KPMG's EU Tax Centre

CJEU decision in the Masco Denmark and Damixa case

Freedom of establishment – Disparity – Tax exemption on interest income – Thin capitalization

On December 21, 2016 the Court of Justice of the European Union ("CJEU" or "Court") rendered its decision on the questions referred in the Masco Denmark ApS and Damixa ApS v Skatteministeriet case (C-593/14). The case concerns Danish corporate tax rules, which allow for a tax exemption on interest income on loans provided by a Danish resident company to Danish affiliated companies, to the extent that the corresponding interest expenditure deduction is denied at the level of the debtor due to thin capitalization rules. The tax exemption is excluded, however, where the affiliated debtor is resident in another Member State. Contrary to the Opinion issued by Advocate General (AG) Kokott, the Court concluded that this difference in treatment constitutes a restriction on the EU freedom of establishment. Furthermore, the difference in treatment was found not to be justified under either the balanced allocation of taxing rights or tax evasion.

Background

Interest income is exempt from Danish tax at the level of the Danish creditor company when a corresponding interest deduction at the level of a debtor company is denied under Danish thin capitalization rules. Such interest income is taxed in Denmark, however, if it derives from a foreign debtor, which is considered thinly capitalized and accordingly not allowed an interest deduction under the foreign rules on corporate income tax.

In the case at hand, a German resident company, Damixa Armaturen, was essentially financed through loans granted by its Danish parent, Damixa, during the years in question (2005 and 2006). The interest on the loan was reclassified to dividend payments in Germany under its thin capitalization rules and consequently was non-deductible for German corporate income tax purposes. Nevertheless, the corresponding interest income was taxed at the level of Damixa in Denmark.

Damixa argued that the interest income would have been exempt if the subsidiary was resident in Denmark instead of Germany and that the difference in treatment infringed the EU freedom of establishment principle (Article 49 of the Treaty on the Functioning of the EU (TFEU)). On May 12, 2016 the AG rendered her Opinion on the questions (see ETF 282), raised by the Danish referring court

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The CJEU decision

The CJEU held that the above legislation constitutes a tax disadvantage as it is liable to render less attractive the exercise by a Danish parent company of its freedom of establishment by deterring it from setting up subsidiaries in other Member States as opposed to setting up Danish subsidiaries. The CJEU found this difference in treatment in the main proceedings in the present case a restriction resulting solely from the Danish rules. These conclusions of the Court are in sharp contrast with those of the AG.

According to settled case law of the CJEU, such a difference in treatment is permissible only if it relates to situations which are not objectively comparable or if it is justified by overriding reasons of public interest.

According to the Court, in each of the two situations the interest income received by the parent company may be subject to economic double taxation or to a series of charges, which is what the legislation at issue in the main proceedings seeks to avoid. Thus, for the purposes of the aim pursued by the Danish national provisions under discussion, the cross-border situation is comparable with the internal situation.

During the proceedings, Denmark argued that the difference in treatment is justified both by the need to ensure a balanced allocation of taxing powers between the Member States and by the need to prevent tax avoidance. The Court, however, ruled that the legislation goes beyond what is necessary in order to attain those objectives.

The Court did agree with the AG’s conclusion that the freedom of establishment cannot be understood as meaning that a Member State is required to draw up its tax rules on the basis of those in another Member State in order to ensure, in all circumstances, that any disparities arising from national tax rules are removed, (the autonomy principle). In other respects it dismissed the AG’s arguments and stressed that granting a tax exemption up to the amount that the subsidiary was not entitled to deduct under the thin capitalization rules of another Member State would not call into question the balanced allocation of the power to impose taxes.

As regards the objective of preventing tax avoidance, the CJEU noted that, in order for an argument based on that justification to succeed, the specific objective of that measure must be to prevent wholly artificial arrangements which do not bear any relation to economic reality and which are designed to avoid payment of the tax normally due on the profits generated by activities carried out on national territory. According to the Court, the Danish legislation did not have such a specific objective, as all resident companies which have granted, for whatever reason, a loan to a thinly capitalized subsidiary resident in another Member State are generally excluded from the tax exemption. Furthermore, the loans granted by Damixa were intended to finance the German subsidiary's losses, and the Court noted that, *a priori*, those losses did not appear to constitute a wholly artificial arrangement entered into for tax reasons alone.

The Court concluded that the disadvantageous difference in tax treatment infringes the EU principle of freedom of establishment under Article 49 TFEU.

EU Tax Centre comment

It is noteworthy that the Court did not agree with the AG's Opinion. The AG based her conclusion - that there was no restriction of the freedom of establishment - on the principle of autonomy and argued that the difference in treatment was in effect a disparity due to the combination of the Danish and German rules. The Court concluded that the difference arose solely as a result of the Danish rules and in effect applied the principle derived from its earlier decision in the Manninen case (C-319/02). This aspect of the decision is particularly significant and may have implications for other Member States which grant tax benefits to counter-balance a tax charge (e.g. in order to mitigate economic double taxation) only to situations where the tax charge arises under the domestic and not under a foreign tax system. It is also noteworthy that the Court rejected the AG's conclusion as regards the potential justifications, in particular concerning the balanced allocation of taxing rights under the EU Interest and Royalties Directive.

Should you have any questions, please do not hesitate to contact KPMG's EU Tax Centre, or, as appropriate, your local KPMG tax advisor.

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