CJEU decision on German rules on cross-border loss relief

Germany – Cross-border loss relief – Final losses – 'Marks & Spencer Exception' - Freedom of establishment – Prevention of double use of losses

On September 22, 2022, the Court of Justice of the European Union (CJEU or the Court) gave its decision in the W case (C-538/20) concerning the compatibility of the German cross-border loss relief rules with EU law.

The Court held that EU law does not preclude a Member State from denying the deduction of final losses incurred by a foreign permanent establishment from the taxable profits of its resident head-office, where the state of residence has waived its power to tax the profits (and losses) of its permanent establishment under a double tax treaty.

Background

The plaintiff was a German securities trading bank that opened a permanent establishment (PE) in the UK in August 2004. The German company decided to close the PE, which was loss making, in 2007. As a result, the PE's losses could no longer be carried forward in the UK for tax purposes.

The plaintiff submitted a claim requesting the German tax authorities to deduct the losses generated in the UK from its German taxable profits. The tax authorities rejected the claim and, following several appeals, the case was brought in front of the German Federal Tax Court (BFH). The BFH acknowledged that based on the double tax treaty concluded between Germany and the UK, profits generated by foreign permanent establishments were tax exempt in Germany and that, consequently, foreign losses should also be disregarded. The BFH was however unsure whether the freedom of establishment required Germany to allow the deduction of 'final losses' – in the sense of the 'Marks & Spencer exception', in cases where the relevant treaty includes the exemption method to avoid double taxation. The case was therefore referred to the CJEU. On

April 10, 2022, Advocate General (AG) Collins of the CJEU recommended that the Court finds that the German rules do not infringe EU law – see E-News Issue 150.

The CJEU decision

In addressing the question, the Court recalled its previous case-law based on which measures restricting companies established in a Member State from carrying out activities in another Member State through a permanent establishment fall within the scope of the freedom of establishment. The Court noted that, under German law, a German head-office would be allowed to deduct for corporate income tax purposes losses of a German PE. Excluding losses incurred by a UK PE from the corporate income tax calculation of its German head-office therefore represented a difference in treatment that could potentially be a restriction on the freedom of establishment.

The CJEU continued by analyzing whether a cross-border situation as the one in the case under dispute was comparable with a domestic situation. In this context, the Court recalled that, as regards measures laid down by a Member State in order to prevent or mitigate the double taxation of a resident company's profits, companies which have a permanent establishment in another Member State are not, in principle, in a comparable situation to that of companies which have a resident permanent establishment. The two situations become comparable where national legislation treats those two categories of establishment in the same way for the purposes of taking into account the losses and profits made by them. On the other hand, where the Member State of the head office waived its power to tax the profits of a non-resident PE based on a double tax treaty, the two situations are not comparable in the light of the measures taken by the Member State in order to prevent or mitigate the double taxation of profits and, symmetrically, the double deduction of resident companies' losses.

Therefore, the Court concluded that denying the utilization of 'final' cross-border losses did not constitute a restriction on the freedom of establishment.

EU Tax Centre comment

Following the 2005 Marks & Spencer case (C-446/03), the issue of utilization of cross-border losses was brought in front of the CJEU several times. In particular, in the Bevola case (C-650/16) the Court concluded that the situation of a Danish company with a Danish PE and that of a Danish company with a non-resident PE are comparable when assessed in light of the purpose of the disputed Danish legislation which disallowed the deductibility of final foreign PE losses, i.e. to prevent the double deduction of losses. The Court observed that this difference in treatment is likely to deter Danish resident companies from exercising their freedom of establishment. However, the Court noted that the restriction may be justified by overriding reasons of the public interest – the need to preserve a balanced allocation of taxing rights between Member States, the need to maintain the fiscal coherence of the Danish tax system, and the need to prevent the double use of losses. As regards in particular the need to maintain the fiscal coherence of the Danish tax system, the Court took the view that there is a direct link between a tax advantage, i.e. the possibility to offset the losses of a PE and the corresponding tax levy, i.e. the inclusion of the same PE's profits in the Danish company's taxable results. Nevertheless, the Court considered that the Danish legislation goes beyond what it necessary to achieve these objectives. The German referring court noted that the Bevola judgement does not provide a clear answer to the question of whether the losses incurred by a foreign PE should not be taken into account for the calculation of the tax payable by the head office, in the particular case where the exemption of foreign profit is provided for by a double taxation convention.

The CJEU clarified that its decision in the W case is not contrary to Bevola since in that case Denmark had unilaterally waived its power to exert its taxing rights over the profits incurred in another Member State, whereas in W Germany waived its rights by virtue of a double tax treaty.

As a result, according to CJEU case law, a distinction would have to be made as to whether the exclusion of final losses in the state of residence is based on a national regulation or a bilateral agreement (double tax treaty). If losses of a permanent establishment are exempt under a double tax treaty, it could nevertheless be possible to take foreign permanent establishment losses into account by way of exception if the national law contains a switch-over or subject-to-tax clause (treaty override) and the application of the double tax treaty exemption method is thereby denied in the specific case.

Should you have any queries, please do not hesitate to contact KPMG's EU Tax Centre, or, as appropriate, your local KPMG tax advisor or KPMG in Germany (Julian Fey).

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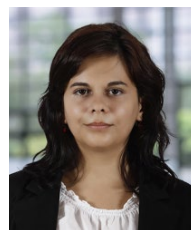

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