Global Tax Alert
News from the EU Competency Group

CJEU rules on application of Danish loss recapture rule to permanent establishments taxed under the credit method

Executive summary

On 17 July 2014, the Court of Justice of the European Union (CJEU) rendered its decision in the Danish case, Nordea Bank Denmark (C-48/13). The case concerns the compatibility of a former Danish rule on the recapture of tax losses of a foreign permanent establishment (PE) with the EU and EEA (European Economic Area) principle of freedom of establishment.\(^1\) The Court ruled that the application of the recapture rule infringed upon the freedom of establishment of the claimant.

Detailed discussion

Background

A Danish tax resident bank carried out banking businesses in Sweden, Norway and Finland through branch offices. The branch offices generated tax losses which were offset against the Danish taxable income of the bank. At that time, Denmark applied a system of worldwide taxation and foreign tax credit. Following a cross-border merger, the branch offices of the Danish bank were closed and the activities were transferred to affiliated companies in the other Nordic countries. The tax losses carried forward by the branch offices could not be taken over by the acquiring companies. The transfer of the activities to the affiliated companies triggered a recapture of the tax losses that the Danish bank had previously deducted in its Danish taxable income under former section 33 D (5) of the Danish Tax Assessment Act.

The Danish Eastern High Court asked the CJEU the following question:

“Are Article 49 of the TFEU (Treaty on the Functioning of the European Union), read together with Articles 54 and 31 of the EEA (European Economic Area) Agreement, read together with Article 34, to be interpreted as precluding a Member State, which allows a company situated in that State to deduct losses on an ongoing basis from a
permanent establishment situated in another Member State, from making full recapture from the company of the losses arising from the permanent establishment (in so far as they are not matched with profits in future years) in the event of the permanent establishment closing down, in connection with which part of the establishment’s business is transferred to an affiliated company within the group which is resident in the same State as the permanent establishment, and where it must be assumed that the possibilities for applying the losses in question have been exhausted?"

**Decision of the CJEU**

In its decision the Court noted that the recognition of losses under the credit method constitutes a tax advantage which applied both in domestic and in cross-border cases. The recapture rule applying to cross-border situations only is qualified as a restriction of the freedom of establishment since it constitutes disadvantageous treatment which may deter a Danish company from carrying on its business through a permanent establishment in an EU/EEA Member State. The cross-border situation was held to be comparable as Denmark had extended its taxing right also to foreign permanent establishments. Nevertheless the CJEU noted that the Danish rule was introduced to avoid the risk of tax avoidance by preventing taxpayers from carrying out their (foreign) activities via a permanent establishment as long as these activities are loss-making and transferring them to subsidiaries (whose profits cannot be taxed in Denmark) at the moment these activities become profitable. Therefore, the Court tested the rule against its prior case law on anti-abuse rules of Member States. It held the in principle a Member States is allowed to tackle arrangements which artificially reduce its tax base. Nevertheless the Court took the view that the contested Danish rule went beyond what was necessary to attain this objective as Danish tax law contained a further rule ensuring that tax authorities can apply the arm’s length principle to intra-group transactions and therefore meet the objective to ensure the aim to safeguard the balanced allocation of taxing rights between Member States. Hence, the Court considered that rule as going beyond what is necessary to attain the objective relating to the need to safeguard the balanced allocation of the power to impose taxes.

**Potential implications**

The Nordea decision is the first case addressing cross-border loss recognition in situations where the credit method applies. In previous decisions the Court considered cases where the Member States applied the exemption method. In these cases the Court developed the doctrine of the need to recognize at least final losses, where the finality was not triggered by legal restriction of the Member State in which the permanent establishment was situated. In the Nordea case the Court did not refer to this doctrine and tested the restrictions to the loss recognition only with respect to the aim of safeguarding a balanced allocation of taxing rights and with the aim of preventing abusive practices of taxpayers. Notably, the Court did not require the taxpayer to present an economic reason for the transaction triggering the Member State’s loss of the entitlement to tax future profits from the permanent establishment.

The decision illustrates that recapture rules need to be proportionate and that taxpayers confronted with a recapture rule in a Member State should assess the compatibility of such recapture with the EU/EEA Treaty freedoms.

---

**Endnote**

For additional information with respect to this Alert, please contact the following:

**Ernst & Young P/S, Copenhagen**
- Jens Wittendorff +45 51 58 28 20 jens.wittendorff@dk.ey.com

**Ernst & Young GmbH Wirtschaftsprüfungsgesellschaft, Munich**
- Dr. Klaus von Brocke +49 89 14331 12287 klaus.von.brocke@de.ey.com
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

EU Competency

© 2014 EYGM Limited.
All Rights Reserved.

EYG No. CM4579

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

ey.com