Executive summary

On 12 June 2018, the Grand Chamber of the European Union (EU) Court of Justice (ECJ) issued its decision on case C-650/16, Bevola, and held that Danish tax law was incompatible with the freedom of establishment set forth in Article 49 of the Treaty on the Functioning of the EU, because a Danish company was precluded from claiming as a tax deduction in Denmark, a final loss suffered by a permanent establishment (PE) in Finland.

Detailed discussion

Facts

The Danish company Bevola maintained a PE in Finland. The PE incurred a loss when it was closed in 2009 that could not be utilized in Finland. Instead, Bevola claimed a tax deduction in its Danish tax return for 2009 for the loss suffered in Finland. A deduction of the loss was disallowed by the tax authorities because section 8(2) of the Danish Corporate Tax Act (CTA) stipulates that the taxable income does not include profits and losses of foreign PEs (territoriality principle). Bevola would only be entitled to claim a tax deduction for the Finnish loss in the Danish tax return by making an election of international joint taxation under section 31 A CTA. However, such an election means that all foreign
entities must be included in the Danish tax return and the election is binding for a period of 10 years. The decision of the tax authorities was confirmed by the National Tax Tribunal on 20 January 2014. The taxpayer filed an appeal with the Eastern High Court claiming that section 8(2) was incompatible with the EU principle of freedom of establishment, because Bevola would have been entitled to claim a tax deduction if the loss had been suffered by a domestic Danish PE. A reference was made to the ECJ decision in case C-446/03, Marks & Spencer.

Question presented to the ECJ
The High Court asked the ECJ to answer the following question:

Does Article 49 TFEU preclude a national taxation scheme such as that at issue in the main proceedings under which it is possible to make deductions for losses in domestic branches, while it is not possible to make deductions for losses in branches situated in other Member States, including in circumstances corresponding to those in the Court's judgment (of 13 December 2005) in Marks & Spencer, C 446/03, EU:C:2005:763, paragraphs 55 and 56, unless the group has opted for international joint taxation on the terms as set out in the main proceedings?

ECJ decision
The ECJ held that section 8(2) causes losses of foreign PEs to be treated less favorable compared to losses of domestic PEs. The fact that a taxpayer could opt for international joint taxation did not make a difference because this scheme was subject to two strict conditions.

The question of the comparability of the situations should be evaluated based on the purpose of the relevant legislation. The purpose of the Danish law was to prevent double taxation of profits and double deduction of losses. With regard to losses suffered by a PE in another Member State which has ceased activity and whose losses cannot be deducted in that Member State, the situation of a company having such a PE was held not to be different from that of a company with a domestic PE, from the point of view of the objective of preventing the double deduction of losses. The ECJ added that the aim of section 8(2) more generally is to ensure that the taxation of a company with such a PE is in line with its ability to pay tax. Yet the ability to pay tax of a company with a foreign PE which has definitively incurred losses is affected in the same way as that of a company whose domestic PE has incurred losses. On this basis, the Court concluded that the difference in treatment concerned situations that were objectively comparable.

According to the ECJ, section 8(2) could be justified by overriding reasons in the public interest relating to the balanced allocation of powers of taxation between Member States, the coherence of the Danish tax system, and the need to prevent the risk of double deduction of losses.

With regard to the proportionality of the provision, the ECJ noted that if it is not possible to deduct the losses of the foreign PE in the Member State in which it is situated, the risk of double deduction of losses no longer exists. In such a case, section 8(2) went beyond what is necessary for pursuing the objectives that could justify it. According to the Court, alignment of the company's tax burden with its ability to pay tax was ensured better if a company with a PE in another Member State is entitled, in that specific case, to deduct from its taxable results the definitive losses attributable to that PE. However, deduction of such losses should be allowed only on the condition that the company demonstrates that the losses are definitive. The burden of proof thus rests with the taxpayer. Referring to Marks & Spencer, the Court stated that a loss is only definitive if it cannot be used in the source state: (1) in the income year in question, (2) in previous income years (carryback), or (3) in future income years by the company itself or a third party (carryforward). In addition, the definitive character of a loss requires that the company has ceased to receive any income from the PE.

In summary, the ECJ held:

In the light of all the above considerations, the answer to the referring court's question is that Article 49 TFEU must be interpreted as precluding legislation of a Member State under which it is not possible for a resident company which has not opted for an international joint taxation scheme, such as that at issue in the main proceedings, to deduct from its taxable profits losses incurred by a permanent establishment in another Member State, where, first, that company has exhausted the possibilities of deducting those losses available under the law of the Member State in which the establishment is situated and, second, it has ceased to receive any income from that establishment, so that there is no longer any possibility of the losses being taken into account in that Member State, which is for the national court to ascertain.
Implications

The decision means that Denmark will be required to amend the territoriality principle set forth in section 8(2) CTA in order to allow taxpayers the right to deduct final losses incurred by PEs in other Member States and European Economic Area (EEA) countries. The case concerns income year 2009, so taxpayers with similar fact patterns should be entitled to reopen tax returns back to 2009 in order to claim a tax deduction for final losses.

The decision should also mean that Danish parent companies are entitled to claim a tax deduction for final losses suffered by nonresident subsidiaries in other EU Member States and EEA countries. In this regard the situation is similar to the situation of foreign PEs, as under Danish law, on the one side, a loss of a resident subsidiary is automatically offset against the profits of a parent company under rules on mandatory joint taxation (section 31 CTA), and, on the other side, a loss of a nonresident subsidiary is only deductible by a parent company, if the parent company makes an election of international joint taxation (section 31 A CTA). Ever since the new rules on joint taxation were incorporated in 2005 following Marks & Spencer, it has been the position of the Danish tax authorities that the Danish rules were compatible with EU law, because taxpayers were allowed to deduct final losses of nonresident subsidiaries by making an election of international joint taxation. Since this reasoning has now been rejected by the ECJ, final losses incurred by nonresident subsidiaries should also be tax deductible for Danish parent companies.

The decision is also expected to have an impact on the tax laws of several other EU Member States and EEA countries that currently do not allow final losses of nonresident PE and subsidiaries to be tax deductible.

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