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ISSUE:

ECJ PUBLISHES ITS JUDGMENT IN THE CASE OF LIDL BELGIUM (C-414/06)

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I. TENOR OF THE DECISION

On 15 2008, the European Court of Justice (ECJ) decided that it is not contrary to Community Law for a Member State to disallow the deduction by resident companies of losses incurred by their permanent establishment situated in another Member State, as long as the income relating to that permanent establishment is taxed in the latter Member State according to the respective double taxation convention and the incurred losses can be taken into account in taxation of the prospective income of that permanent establishment.

Although the decision appears negative at first view for the cross-border use of losses incurred in foreign countries, it is in line with the principles developed by the ECJ in the case of Marks & Spencer and makes it clear under which conditions a carried-forward loss incurred in foreign countries can be used by a principal company.

II. FACTS

The taxpayer, Lidl Belgium, is a limited commercial partnership registered in Germany. The company had a permanent establishment in Luxembourg for distributing goods, which generated a loss in the year in question (1999). Lidl Belgium sought to take the loss incurred by its non-resident permanent establishment into account in the assessment of its liability to German taxation in 1999. In a subsequent tax year (2003) the permanent establishment made a profit and Lidl Belgium could deduct the 1999 loss, which it had carried forward, in the computation of its liability to Luxembourg tax.

III. LEGAL CONTEXT

Under the Convention between the Grand Duchy of Luxembourg and the Federal Republic of Germany for the avoidance of double taxation (the Germany-Luxembourg treaty) income incurred by a Luxembourg permanent establishment of a German company is taxable in Luxembourg. To avoid double taxation Germany accordingly exempts the income of the permanent establishment from tax. This non-recognition principle also applies to negative income (losses) in-

curred by the Luxembourg permanent establishment, so that the taxpayer cannot take them into account with respect to German taxation. However, under domestic German tax law, the losses incurred by a resident (German) permanent establishment are deductible for the purposes of German taxation.

IV. IS THE GERMAN TAX REGIME IN LINE WITH EU LAW?

a) Freedom of establishment and its infringement

In the first part of its judgment, the ECJ held that different treatment of losses as between a domestic permanent establishment and a foreign permanent establishment was indeed an infringement of the freedom of establishment guaranteed by Article 43 of the EC Treaty.

b) Is the infringement justified ?

However, under current jurisprudence, an infringement of the freedom of establishment is not contrary to Community Law, if it pursues a legitimate objective and is not disproportionate.

The ECJ regards the following objectives to be justified in this respect:

- preservation of the allocation of taxing powers among the Member States concerned,
- prevention of the risk that losses may be used twice,
- containment of the risk of tax avoidance.

In its judgment, the ECJ observed that not all of these objectives need to be present in any particular case in order for the infringement of the freedom of establishment to be justified. On the other hand, the ECJ left it open as to whether one single legitimate objective is sufficient, because in this case it found that two objectives were present - namely preservation of the allocation of the power to impose taxes between the Member States and prevention of the double use of losses.

c) Was the loss denial disproportionate?

A second condition for an infringement of the right to freedom of establishment is that the offending measure must not go beyond what is necessary to attain the objectives pursued (the principle of proportionality). Therefore the ECJ regards the denial of a loss deduction to be disproportionate if it results in a definitive exclusion of the right to deduct altogether. However, in the case of Lidl Belgium the loss deduction was not definitively excluded. In fact, Luxembourg law allowed the loss of the permanent establishment to be carried forward, and indeed, Lidl Belgium was actually able to deduct the loss in a subsequent year. In conclusion, therefore, the provision of German law that prevented the deduction of the loss in Germany was both proportionate and served a legitimate objective.

V. COMMENT

This case confirms the landmark judgment in Marks & Spencer (C-446/03) on the use of cross-border losses. In that case, the ECJ held that a Member State must allow a resident company to deduct a loss incurred by a foreign subsidiary (resident in another Member State) if but only if the possibility that the loss might be deductible in the foreign subsidiary's home state or elsewhere in the European Union was definitively excluded.

However, this latest judgment takes no account of the potentially significant cash-flow disadvantage that may arise if the taxpayer has to accept an indefinite delay before the loss becomes deductible. Moreover, the ECJ did not consider that, under German domestic law, a definitive loss must primarily be set off against other income of the same year of assessment. However, a long time may well pass until a foreign loss incurred by a permanent establishment or subsidiary becomes definitively excluded from set-off in the Member State of the permanent establishment or subsidiary, as the ECJ requires. In the meantime, there is thus the danger that in the home state the assessment for the year in which the loss is incurred becomes time-barred, thus preventing any set-off of the loss even in the home state of the principal entity or parent company. Therefore, the assessments for the respective tax years should be kept open in the home state unless the losses have been set off in the foreign state or until they become definitively excluded from such set-off.

It is also the case that the ECJ has not clarified in what circumstances and when a loss can be considered as definitively no longer deductible. In this respect, we can expect further litigation before the European Court.

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