

## Luxembourg – Losses of EU Permanent Establishments

### June 2008

On 15 May 2008, the European Court of Justice (ECJ) ruled in the Lidl Belgium case (C-414/06) that it is not contrary to EC law for a company located in one Member State (MS) not to be able to deduct the losses incurred by its Permanent Establishments (PE) situated in another MS, where, by virtue of a double tax treaty (DTT), that PE's income is taxed in the latter MS and the losses can be carried forward against that PE's income in future accounting periods. Consequently, the ECJ did not totally follow the opinion of the Advocate General in the same case (for further details on the AG's opinion, please refer to the PwC Flash News, "Luxembourg – Losses of EU Permanent Establishments", March 2008).

### Description of the facts

The case refers to the tax treatment in Germany of losses incurred by a Luxembourg PE ("Lux PE") of a German resident company ("GermanCo"). GermanCo asked to offset the losses of the Lux PE against its German taxable profits. The German tax authorities considered that the losses incurred by the Luxembourg PE could not be deducted in Germany, as profits recorded by the Luxembourg PE were tax exempt under the Luxembourg – Germany double tax treaty (principle of symmetry). The German Federal Finance Court had expressed doubts on the compatibility of this national measure with EC law principles and referred the case to the ECJ.

### ECJ judgment

#### *Restriction on the freedom of establishment*

The ECJ considers that the situation of a company which has its registered office in Germany and a PE in another MS is less favourable than it would be if it were to have a PE established in Germany. In this respect, under the German rules in question, the losses incurred by a PE were taken into account in calculating the head office's taxable income only if the losses were incurred by a PE situated in the same MS as that in which the principal company is established. Therefore, the German tax regime at issue is in breach of the freedom of establishment principle.

#### *Justification of the restriction*

The ECJ accepted, however, that such restriction may be justified by the need to preserve the allocation of the taxing powers between the MSs concerned, and the need to prevent losses from being deducted twice.

Firstly, the ECJ considers that if companies were given the right to choose in which MS their losses would be taken into account, this would seriously undermine the balanced allocation of taxing rights. As the home state does not have the right to tax under the DTT, the objective of preserving the allocation of the taxing rights between the MSs justifies the German tax measure in question, since it safeguards the symmetry between the right to tax profits and the right to deduct losses.

Secondly, the ECJ considers that there is clearly a danger that the same losses will be used twice. For instance, a company might deduct, in the MS in which its headquarters is situated, the losses incurred by a PE situated in another MS and, in spite of this, the same losses might also be taken into account subsequently in the MS in which the PE is situated, when that PE generates profits in the future.

Finally, the ECJ did not follow the AG's opinion on the principle of proportionality: it dismissed the recapture mechanism proposed by the AG in order to avoid cash flow disadvantages (for further details on the AG's opinion, please refer to the PwC Flash News, "Luxembourg – Losses of EU Permanent Establishments", March 2008). Instead, the ECJ referred to its Marks & Spencer judgment in which it has held that a measure might be disproportionate where a non-resident subsidiary has exhausted the possibilities for taking losses into account in the MS where the losses were incurred. As the Lux PE had, in fact, been able to offset its losses in a subsequent tax year in which the Lux PE generated profits (according to Luxembourg tax legislation), the ECJ found that the claimant has not shown in the case at hand that the conditions laid down in Marks & Spencer were fulfilled. Consequently, the German tax measure at issue in the main proceedings has been regarded as proportionate.

## Consequences for Luxembourg taxpayers

**In this judgment, the ECJ did not totally follow the AG's opinion and clearly limited the possibilities for Luxembourg taxpayers to deduct losses incurred by their EU PEs where, according to the judgment, there is no possibility for those losses to be taken into account in the taxation of income of these PEs in future accounting periods.**

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