JUDGMENT OF THE COURT (Fourth Chamber)

21 December 2016 (*)

(Reference for a preliminary ruling — Freedom of establishment — Tax legislation concerning thin capitalisation of subsidiaries — Inclusion in the taxable income of a lending company of the loan interest paid by a non-resident borrowing subsidiary — Tax exemption for interest paid by a resident borrowing subsidiary — Balanced allocation between Member States of the power to impose taxes — Need to prevent the risk of tax avoidance)

In Case C?593/14,

REQUEST for a preliminary ruling under Article 267 TFEU from the Vestre Landsret (Western Regional Court, Denmark), made by decision of 16 December 2014, received at the Court on 19 December 2014, in the proceedings

Masco Denmark ApS,

Damixa ApS

v

Skatteministeriet,

THE COURT (Fourth Chamber),

composed of T. von Danwitz, President of the Chamber, E. Juhász, C. Vajda (Rapporteur), K. Jürimäe and C. Lycourgos, Judges,

Advocate General: J. Kokott,

Registrar: V. Tourrès, Administrator,

having regard to the written procedure and further to the hearing on 3 March 2016,

after considering the observations submitted on behalf of:

– Masco Denmark ApS and Damixa ApS, by J. Krogsøe, advokat,

– the Danish Government, by C. Thorning, acting as Agent, assisted by S. Horsbøl Jensen, advokat,

– the European Commission, by M. Clausen and W. Roels, acting as Agents,

after hearing the Opinion of the Advocate General at the sitting on 12 May 2016,

gives the following

Judgment

1 The present request for a preliminary ruling concerns the interpretation of Articles 49 TFEU and 54 TFEU.

2 The request has been made in proceedings between, on the one hand, Masco Denmark ApS and Damixa ApS and, on the other, the Skatteministeriet (Ministry of Fiscal Affairs, Denmark) concerning the decision of the national tax authority to include, in the taxable income of a lending parent company established in Denmark, the interest paid by a borrowing subsidiary established in Germany which cannot be deducted from the taxable profits of that subsidiary by reason of the German legislation on thin capitalisation.

Legal context

Danish law

3 As a rule, Danish companies are liable to pay tax on interest income in accordance with Paragraph 4(e) of the Lov om Indkomst- og Formueskat til Staten (Danish Law on Income and Property Tax owed to the State).

4 Under Paragraph 6(e) of that law, Danish companies are generally entitled to a deduction in respect of interest expenditure.

5 However, a company's right to deduct interest expenditure is limited in the event of thin capitalisation, pursuant to Paragraph 11 of the Lov om indkomstbeskatning af aktieselskaber m.v. (Danish Law on, inter alia, Corporation Tax) ('SEL'). Paragraph 11(1) of that law, in the version applicable to the tax years at issue, provided as follows:

'If a company or association

(1) is covered by Paragraph 1(1)(1)-(2a), (2d)-(2g) and (3a)-(5b), [that is to say, is resident for tax purposes in Denmark];

(2) is indebted to legal persons referred to in Paragraph 2(1) of the [Lov om påligningen af indkomstskat til staten / ligningsloven (Law on the assessment of State income tax)] [that is to say, indebted to shareholders or to affiliated companies; "controlled debt"]; and

(3) that company's or association's liabilities (debt) in relation to the company's equity at the end of the tax year exceed a ratio of 4:1,

interest expenditure and losses relating to the excess part of the controlled debt cannot be deducted. ... Loans from third parties for which the controlling shareholders or their affiliated companies have provided security, directly or indirectly, shall be deemed to be controlled debt. The exclusion of the deduction shall not apply in so far as the company demonstrates that similar financing can be obtained between independent parties. The deduction shall be excluded only if the controlled debt exceeds DKK 10 million [approximately EUR 1 344 528]. The exclusion of the deduction shall apply solely to that portion of the controlled debt which was to be converted into equity, so that the debt-to-equity ratio at the end of the tax year is 4:1.'

6 The rules on thin capitalisation were introduced by Law No 432 of 26 June 1998 and were applicable only if the creditor was not resident for tax purposes in Denmark. However, Law No 221 of 31 March 2004 ('the law amending the SEL') amended Paragraph 11 of the SEL in such a way that that provision now also applies where both the debtor and creditor are resident for tax purposes in Denmark.

7 At the same time, Paragraph 11(6) was added to the SEL. That provision is worded as follows:

‘Interest and currency exchange gains shall not be included in the calculation of taxable income for taxable persons [corporate taxpayers and tax-paying permanent establishments of foreign companies] where the debtor is not entitled to a deduction for the corresponding amounts under subparagraph 1 ...’

8 It is apparent from the drafting history of the law amending the SEL that ‘it is suggested, by way of corollary for bringing Danish companies within the scope of the limitation on deduction, that companies resident for tax purposes in Denmark be allowed tax relief in respect of the interest received from indebted companies which, pursuant to the new rules, are unable to deduct that interest, in the same way as Denmark does not tax companies in other Member States in respect of such interest’.

German law

9 The German thin capitalisation legislation applicable to the tax years 2005 and 2006 was to be found in Paragraph 8a of the Körperschaftsteuergesetz (German Law on Corporation Tax). Under that provision, a company is considered to be thinly capitalised where the amount of borrowed capital exceeds by 1.5 times its equity capital. If that is the case, deduction of loan interest expenditure is not allowed unless the company demonstrates that the relevant loans could have been obtained from a third party on equivalent terms.

The dispute in the main proceedings and the question referred for a preliminary ruling

10 Damixa is a Danish company specialising in the production and sale of water taps. In the tax years 2005 and 2006 Damixa was a subsidiary of Masco Denmark and was represented on the German market by its wholly-owned subsidiary Damixa Armaturen.

11 Following a number of tax years in which significant losses were incurred, Damixa Armaturen found itself in financial distress in 2005 and 2006. As at 31 December 2005, its accumulated losses amounted to EUR 28 million, which resulted in negative equity of EUR 22.8 million, while, as at 31 December 2006, the accumulated losses of that subsidiary amounted to EUR 30.9 million, which resulted in negative equity of EUR 25.8 million.

12 The deficits in Damixa Armaturen were essentially financed through loans granted by Damixa. Damixa Armaturen owed Damixa EUR 24.8 million at the end of the tax year 2005 and EUR 27.7 million at the end of the tax year 2006.

13 Damixa granted those loans at an interest rate of 0.5% above the base rate. Accordingly, the interest charges on the loans amounted to DKK 3 935 980 (approximately EUR 529 203) for the tax year 2005 and to DKK 5 648 765 (approximately EUR 759 492) for the tax year 2006.

14 In its declaration of taxable income in Germany, Damixa Armaturen did not deduct those interest charges as interest expenditure was regarded as constituting non-deductible distributed profits under the German rules limiting deduction in cases of thin capitalisation.

15 Damixa, in its tax return, did not declare that interest income as part of its taxable profits as it took the view that the Danish rules on taxation of interest received were contrary to EU law.

16 By a decision of 1 April 2008, the Danish tax authorities held that interest received on the loans granted by Damixa to Damixa Armaturen in 2005 and 2006 had to be included in the taxable

profits of Damixa.

17 An appeal brought against that decision before the Landsskatteretten (National Tax Appeals Commission, Denmark) was dismissed by decision of 16 December 2011.

18 By application of 15 March 2012, Masco Denmark and Damixa brought an action against that negative decision before the Retten i Odense (Odense Court, Denmark) and subsequently brought an appeal against the resulting judgment delivered by that court before the Vestre Landsret (Western Regional Court, Denmark).

19 Before the referring court, Masco Denmark and Damixa argued that the Danish rules at issue were contrary to Article 49 TFEU, read in conjunction with Article 54 TFEU, in so far as they adversely, and without due justification, affected the freedom of establishment. In that regard, they pointed out that the exemption provided for in Paragraph 11(6) of the SEL applies only where the borrowing subsidiary is resident in Denmark.

20 That view is disputed by the Ministry of Fiscal Affairs, which contends that the legislation at issue in the main proceedings is consistent with the provisions of EU law. According to the Ministry, it is the application of the German tax rules which has led to the situation in which Damixa Armaturen was unable to make a deduction for interest expenditure in its tax return. The Ministry also takes the view that the tax disadvantage at issue in the main proceedings has arisen as a result of the parallel exercise by the Kingdom of Denmark and the Federal Republic of Germany of their powers of taxation.

21 In those circumstances, the Vestre Landsret (Western Regional Court) decided to stay the proceedings and to refer the following question to the Court of Justice for a preliminary ruling:

‘Does Article 43 EC, read in conjunction with Article 48 EC (now, respectively, Article 49 TFEU and Article 54 TFEU), preclude a Member State from not allowing a resident company a tax exemption for interest income where an affiliated company within the same group resident in another Member State is not entitled to a tax deduction for the corresponding interest expenditure as a result of rules (as in the present case) in the relevant Member State on interest deduction limitation in cases of thin capitalisation, where the Member State allows a resident company a tax exemption for interest income in cases where an affiliated company within the same group in that same Member State is not allowed a tax deduction for the corresponding interest expenditure as a result of national rules (as in the present case) on interest deduction limitation in cases of thin capitalisation?’

Consideration of the question referred

22 By its question, the referring court is asking, in essence, whether Article 49 TFEU, read in conjunction with Article 54 TFEU, must be interpreted as precluding legislation of a Member State, such as that at issue in the main proceedings, which allows a resident company a tax exemption in respect of interest paid by a resident subsidiary, in so far as that subsidiary is not entitled to a tax deduction for the corresponding interest expenditure by reason of rules limiting interest deduction in cases of thin capitalisation, but does not allow such an exemption where the subsidiary is resident in another Member State.

23 It should be noted that freedom of establishment, conferred on European Union nationals by Article 49 TFEU, entails, according to Article 54 TFEU, for companies or firms formed pursuant to the law of a Member State and having their registered office, central administration or principal place of business within the European Union, the right to exercise their activity in another Member State through a subsidiary, a branch or an agency (see, to that effect, judgment of 21 February

2013, *A*, C?123/11, EU:C:2013:84, paragraph 30 and the case-law cited).

24 Whilst the provisions of the FEU Treaty concerning freedom of establishment are directed to ensuring that foreign nationals and companies are treated in the host Member State in the same way as nationals of that State, they also prohibit the Member State of origin from hindering the establishment in another Member State of a company incorporated under its legislation, in particular through a subsidiary (see, to that effect, judgment of 17 December 2015, *Timac Agro Deutschland*, C?388/14, EU:C:2015:829, paragraph 21 and the case-law cited).

25 Freedom of establishment is hindered if, under a Member State's tax regime, a resident company having a subsidiary in another Member State suffers a disadvantageous difference in treatment for tax purposes compared with a resident company having a subsidiary in the first Member State (see, to that effect, judgment of 17 December 2015, *Timac Agro Deutschland*, C?388/14, EU:C:2015:829, paragraph 22 and the case-law cited).

26 In the present case, it must be held that a tax exemption, such as that at issue in the main proceedings, accorded under national legislation to a resident company in relation to interest paid by a resident subsidiary, in so far as that subsidiary is not entitled to a tax deduction for the corresponding interest expenditure by reason of national rules limiting interest deduction in cases of thin capitalisation, constitutes a tax advantage.

27 The exclusion of such an advantage for a resident parent company in relation to interest paid to that company by a subsidiary resident in another Member State, in so far as that interest cannot be deducted from the taxable profits of that subsidiary by reason of the legislation of that Member State on thin capitalisation, is liable to render less attractive the exercise by that parent company of its freedom of establishment by deterring it from setting up subsidiaries in other Member States.

28 Such a difference in treatment, which in the main proceedings in the present case results solely from the Danish rules, is permissible only if it relates to situations which are not objectively comparable or if it is justified by an overriding reason in the public interest (judgment of 6 October 2015, *Finanzamt Linz*, C?66/14, EU:C:2015:661, paragraph 30 and the case-law cited).

29 First, it must be ascertained whether the situations at issue are objectively comparable. For that purpose, it must be recalled that the comparability of a cross-border situation with an internal situation must be examined having regard to the aim pursued by the national provisions at issue (judgment of 6 October 2015, *Finanzamt Linz*, C?66/14, EU:C:2015:661, paragraph 31 and the case-law cited).

30 As set out in paragraph 8 above, it is apparent from the drafting history of the law amending the SEL that the tax exemption at issue was introduced in order to avoid a situation in which parent companies resident in Denmark would be taxed on interest paid to them by subsidiaries of theirs to which they had granted loans in cases where those subsidiaries were not entitled to a tax deduction, in whole or in part, in respect of the corresponding interest expenditure as a result of rules limiting the right to deduct interest paid in cases of thin capitalisation.

31 Consequently, it must be held that, on the one hand, the situation in which a resident parent company which has granted a loan to a resident subsidiary that is subject to thin capitalisation rules and, on the other hand, the situation in which a resident parent company which has granted a loan to a non-resident subsidiary that is subject to thin capitalisation rules in the Member State in which it is resident for tax purposes are, in the light of that objective, objectively comparable. In each of those situations, the interest income received by the parent company is liable to be subject to economic double taxation or to a series of charges, which is what the legislation at issue in the

main proceedings seeks to avoid.

32 Secondly, it is necessary to examine whether such a difference in treatment is justified by an overriding reason in the general interest.

33 In order to be so justified, such a difference must be appropriate for ensuring attainment of the objective pursued and must not go beyond what is necessary to achieve that objective (judgment of 25 February 2010, *X Holding*, C?337/08, EU:C:2010:89, paragraph 26 and the case-law cited).

34 The Kingdom of Denmark submits that the difference in treatment at issue in the main proceedings is justified both by the need to ensure a balanced allocation of taxation powers between the Member States and by the need to prevent tax avoidance.

35 As regards the need to safeguard the balanced allocation of taxation powers between the Member States, this may be capable of justifying a difference in treatment where the system in question is designed to prevent conduct liable to jeopardise the right of a Member State to exercise its powers of taxation in relation to activities carried on in its territory (judgment of 21 February 2013, *A*, C?123/11, EU:C:2013:84, paragraph 41 and the case-law cited).

36 Thus, the preservation of the allocation of the power to impose taxes between Member States might make it necessary to apply to the economic activities of companies established in one of those States only the tax rules of that State in respect of both profits and losses (judgment of 21 February 2013, *A*, C?123/11, EU:C:2013:84, paragraph 42 and the case-law cited).

37 To give companies the right to elect to have their losses taken into account in the Member State in which they are established or in another Member State would seriously undermine a balanced allocation of the power to impose taxes between the Member States in that the taxable bases would be altered in both States to the extent of the losses transferred (judgment of 21 February 2013, *A*, C?123/11, EU:C:2013:84, paragraph 43).

38 In the present case, it must be held that legislation of a Member State, such as that at issue in the main proceedings, which limits the tax exemption in question solely to interest paid by a resident subsidiary appropriately ensures a balanced allocation of the power to impose taxes between the Member States concerned. By allowing a resident company which has granted a loan to a subsidiary resident in another Member State to deduct all interest paid by its subsidiary where that subsidiary is not entitled to deduct that interest expenditure under the thin capitalisation rules of that other Member State, the Member State in which the parent company is resident would be foregoing, on the basis of the choice made by companies having relationships of interdependence, its right to tax the interest income received by the parent company depending on the rules on thin capitalisation adopted by the Member State of residence of the subsidiary, which is what the legislation at issue in the main proceedings seeks to avoid.

39 However, legislation such as that at issue in the main proceedings goes beyond what is necessary in order to attain that objective.

40 It is true that freedom of establishment cannot be understood as meaning that a Member State is required to draw up its tax rules on the basis of those in another Member State in order to ensure, in all circumstances, taxation which removes any disparities arising from national tax rules, given that the decisions taken by a company as to the establishment of commercial structures abroad may be to the company's advantage or not, depending on the circumstances (judgment of 23 October 2008, *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt*, C?157/07, EU:C:2008:588, paragraph 50 and the case-law cited).

41 Thus, in a context such as that in the case in the main proceedings, Article 49 TFEU, read in conjunction with Article 54 TFEU, cannot have the effect of requiring the Member State of residence of a parent company which has granted a loan to a subsidiary resident in another Member State, to go beyond according a tax exemption to that parent company for the amount of interest expenditure which could not be deducted by the subsidiary if the thin capitalisation rules of the first Member State were to be applied. Accordingly, those articles cannot have the effect of requiring the Member State of residence of that parent company to grant that company a tax exemption for a higher amount originating from the tax system of another Member State, if the first Member State is not to see its fiscal autonomy limited by the exercise of fiscal power of the other Member State (see, by analogy, judgment of 30 June 2011, *Meilicke and Others*, C?262/09, EU:C:2011:438, paragraph 33 and the case-law cited).

42 Nevertheless, it should be stressed that, where a Member State has a system for preventing or mitigating a series of charges to tax or economic double taxation for dividends paid to residents by resident companies, it must treat dividends paid to residents by non-resident companies in the same way (judgment of 30 June 2011, *Meilicke and Others*, C?262/09, EU:C:2011:438, paragraph 29 and the case-law cited).

43 In a context such as that of the case in the main proceedings, concerning a parent company in one Member State whose subsidiary is resident in another Member State which has more stringent rules on thin capitalisation, the granting, by the Member State in which the parent company is resident, of a tax exemption to that parent company for interest paid by that subsidiary up to the amount that the subsidiary was not entitled to deduct under the thin capitalisation rules of the latter Member State would not call into question the balanced allocation of the power to impose taxes and would constitute a measure less restrictive of freedom of establishment than that provided for in the legislation at issue in the main proceedings (see, by analogy, judgments of 12 December 2006, *Test Claimants in the FII Group Litigation*, C?446/04, EU:C:2006:774, paragraph 52, and of 30 June 2011, *Meilicke and Others*, C?262/09, EU:C:2011:438, paragraph 32).

44 As regards the objective of preventing tax avoidance, it should be noted that, in order for an argument based on that justification to succeed, the specific objective of that measure must be to prevent wholly artificial arrangements which do not bear any relation to economic reality and which are designed to avoid payment of the tax normally due on the profits generated by activities carried out on national territory (see, to that effect, judgment of 17 December 2015, *Timac Agro Deutschland*, C?388/14, EU:C:2015:829, paragraph 42 and the case-law cited).

45 In that regard, it should be noted that the legislation at issue in the main proceedings does not have the specific purpose of preventing wholly artificial arrangements, set up to circumvent Danish tax legislation, from attracting tax benefits; rather, it generally excludes all resident companies which have granted, for whatever reason, a loan to a thinly capitalised subsidiary resident in another Member State from attracting the relevant tax benefits (see, by analogy, judgment of 12 December 2002, *Lankhorst-Hohorst*, C?324/00, EU:C:2002:749, paragraph 37 and the case-law cited).

46 Furthermore, it seems clear from the file before the Court that the loans granted by Damixa were intended to finance the main portion of the deficit of Damixa Armaturen, which was in major financial difficulties at the material time, and therefore, *a priori*, those losses did not appear to constitute a wholly artificial arrangement entered into for tax reasons alone.

47 In those circumstances, the answer to the question referred is that Article 49 TFEU, read in conjunction with Article 54 TFEU, must be interpreted as precluding legislation of a Member State, such as that at issue in the main proceedings, which allows a resident company a tax exemption for interest paid by a resident subsidiary, in so far as that subsidiary is not entitled to a tax deduction for the corresponding interest expenditure by reason of the rules limiting the deduction of interest paid in cases of thin capitalisation, but which excludes the exemption that would result from the application of its own thin-capitalisation legislation in the case where the subsidiary is resident in another Member State.

Costs

48 Since these proceedings are, for the parties to the main proceedings, a step in the action pending before the national court, the decision on costs is a matter for that court. Costs incurred in submitting observations to the Court, other than the costs of those parties, are not recoverable.

On those grounds, the Court (Fourth Chamber) hereby rules:

Article 49 TFEU, read in conjunction with Article 54 TFEU, must be interpreted as precluding legislation of a Member State, such as that at issue in the main proceedings, which allows a resident company a tax exemption for interest paid by a resident subsidiary, in so far as that subsidiary is not entitled to a tax deduction for the corresponding interest expenditure by reason of the rules limiting the deduction of interest paid in cases of thin capitalisation, but which excludes the exemption that would result from the application of its own thin-capitalisation legislation in the case where the subsidiary is resident in another Member State.

* Language of the case: Danish.