taxpayer may not be excessive,[187] which could imply that a Member State will be obliged to make a request for an international exchange of information to avoid such results. The Grand Chamber will now have to deliberate on these issues and will hopefully come to a conclusion different from the one in the *Twoh* case.

[187] ECJ 25 April 2008, C-201/05, *CFC and Dividend Group Litigation* (unpublished), para. 84.

Germany II:
The Glaxo Wellcome, STEKO, Ernst & Young and Krankenheim Ruhesitz Cases

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I. Introduction

I have to start with by disappointing the reader: None of the cases I am presenting concerns legislation effective to date. This is somehow symptomatic for the interaction between Member States and EU jurisdiction. On the one hand, it is a sign that the German legislator slowly understands his duties under Art. 10 EC of the EC Treaty, and sometimes even acts pro-actively, not waiting to be condemned by the European Court of Justice (ECJ). That was true for the reform of the corporate income tax system in 2000 and the new Reorganization Tax Act of 2006. On the other hand, the German tax legislator does not abstain from new infringements of the fundamental freedoms. Despite the ECJ's perseverance in rejecting limiting the retroactivity of its decisions, the threat of a preliminary ruling some years later does not discipline the legislator. We experienced this recently in the German business tax reform 2008, which will probably give reason for further references presented here in a few years, and maybe by then the provisions at issue will have been modified or abolished.

The cases I will present are located in the realm of business taxation. *Glaxo Wellcome* and *STEKO* deal with special features of the former corporate income tax system and its reform in 2001/2002. *Ernst & Young* is a case concerning reorganizations prior to the reform of the Reorganization Tax Act in 2006 and in *Krankenheim Ruhesitz* restrictions of cross-border loss offsetting are challenged.

II. Glaxo Wellcome

2.1 Introduction

The *Glaxo Wellcome* case is, like the recently decided *Burda* case, another "leftover" from the former German corporate tax imputation system. It concerns a provision which was meant to keep non-resident shareholders from circumventing the exclusion from the imputation credit. At first glance the case shows similarities with the *ACT* case[1] and the *Burda* case,[2] both of which deal with the question whether non-resident shareholders can claim integration in the relief mechanisms for avoiding economic double taxation of dividends. However, if one looks closer, the *Glaxo Wellcome* case turns out to concern single taxation in the case of cross-border sale of shares. Therefore, in my view a simple transfer of the *ACT* and *Burda* findings is not adequate.

2.2 Relevant German legislation

From 1977–2001 Germany applied an imputation system of corporate tax, granting a fully creditable and refundable credit for the paid corporate income tax to in-

1 ECJ 12 December 2006, C-374/04, *ACT Group Litigation* [2006] ECR I-11673.
2 ECJ 26 June 2008, C-84/06, *Burda* (not yet published).

dividual and corporate shareholders. The system was in a double sense limited to domestic situations. On the one hand, the credit was only granted for corporate tax paid in Germany.[3] On the other hand, non-resident shareholders could not utilize the tax credit because,they were not assessed for tax in Germany. They were – if at all – taxed on their dividend income with a final withholding tax.

The imputation system was applicable only to dividend distributions and liquidation distributions. In the case of realization of reserves by a sale of the shares, taxation depended on the status of the acquirer as well as the seller with the result that the profit earned in the corporation was either taxed once, not taxed at all, or double taxed. If the shares were held as business assets by both parties to the transaction (seller and acquirer), the capital gain was taxable per se but a double taxation could be avoided by subsequent write downs of the shares based on a distribution. However, if the shares were acquired from a shareholder who held a shareholding of less than 25% as private assets, the seller was not taxed on the capital gain. Nevertheless, the acquirer was still able to write down the shareholding due to subsequent distributions if he acquired the shareholding as a business asset.

		Seller		
		share = private asset ≤ 25%	share = private asset > 25%	share = business asset
Acquirer	Share = private asset	Capital gain tax free, no write down **Single taxation**	Capital gain taxable, no write down **Double taxation**	Capital gain taxable, no write down **Double taxation**
	Share = business asset	Capital gain tax free + write down **No taxation**	Capital gain taxable + write down **Single taxation**	Capital gain taxable + write down **Single taxation**

In 1980 the legislator adopted Sec. 50c ITA. It disallowed for tax purposes write downs of shares based on a subsequent distribution if shares in a German resident corporation were acquired from a shareholder not entitled to the imputation tax credit by a shareholder who was entitled to the credit. The ban on write downs was limited to a ten-year period after the acquisition. Technically, the acquired shares were "stained" with a blocking amount (Sperrbetrag) reflecting the difference

3 Infringing the free movement of capital see ECJ 6 March 2007, C-292/04, *Meilicke* [2007] ECR I-1835 following 7 September 2004, C-319/02, *Manninen* [2004] ECR I-7477.

between the acquisition cost and the nominal value of the shares. Distributions subsequent to the acquisition lowered the blocking amount but were not recognized, thus reducing the profit for tax purposes if not they did not exceed the blocking amount. The blocking amount was attached to the shares until it was used up and, thus, in principle persisted during further transfers by sale or reorganization.

Sec. 50c EStG was meant to ensure that non-resident shareholders were not able to circumvent the exclusion from the imputation system by realizing the profits earned in the corporation through a sale of the shares to a resident shareholder instead of receiving a distribution.[4]

The denial of write downs is justified only if the capital gain is not taxed. Hence, during the legislative process the German legislative bodies had already requested the fiscal authorities to abstain from application of Sec. 50c para. 1 ITA if the capital gain was taxed in Germany. In this regard, the German Federal Ministry of Finance (Bundesfinanzministerium) issued an administrative decree (R 227d para. 3 sentence 2 EStR),[5] to the effect that at the authorities' discretion the denial of write downs may not be applied if the capital gain has actually been taxed in Germany.

In 1997 Sec. 50c ITA was amended[6] by a para. 11 extending the denial of write downs to acquisitions from shareholders entitled to the imputation tax credit if the acquirer could not prove that the capital gain was taxable in the hands of the prior shareholder (predecessor in title). The amendment was explicitly directed against tax planning strategies making use of the high threshold at that time (shareholdings above 25% of the capital) for taxing capital gains from private investments in corporate shares which overall, in combination with the write down, allowed a double dip.[7]

In 2001 Germany turned from the corporate tax imputation system to a classical system, applying at the corporate level a participation exemption to dividends and capital gains from shares (Sec. 8b paras. 1 and 2 Corporate Tax Act [CTA]). As a logical consequence, any write down of shares has been excluded (Sec. 8b para. 3 sentence 3 CTA). Sec. 50c Income Tax Act (ITA) was abolished.

2.3 Facts of the case

The case referred by the Bundesfinanzhof[8] to the ECJ concerns a quite complex reorganization which took place before the para. 11 amendment. Such reorgan-

4 Bundestags-Drucksache 8/3648, pp. 22 et seq.; Bundestags-Drucksache 8/4157, pp. 5 et seq.
5 BStBl I 1981, Sondernummer 1/1982, p. 293.
6 By Gesetz zur Fortsetzung der Unternehmensteuerreform of 29 October 1997.
7 On this rationale for the amendment, see bill of Land Nordrhein-Westfalen, Entwurf eines Gesetzes zum Ausschluss ausschüttungsbedingter Gewinnminderungen, BR-Drucks. 238/87, pp. 2 et seq.; BT-Drucks. 13/901, p. 139; and at length van Lishaut, Gesetz zur Fortsetzung der Unternehmenssteuerreform: Der neue Absatz 11 des § 50c EStG, *DB* 1997, p. 2190.
8 See BFH 23 January 2008, I-R 21/06, *ISTR* 2008, p. 443.

ization structures were commonly employed with the aim of stripping off the Sec. 50c-blocking amount by getting new shares through a merger. The claimant is a German GmbH & Co. KG. It resulted from a double up-stream merger after a Sec. 50c-acquistion in which a German company had acquired 100% of the share capital in another German company from two British Limiteds (99.98% from GG Ltd. and 0.02% from W Ltd.). The issue was whether in the calculation of the conversion loss or gain the blocking amount had to be taken into consideration; this was challenged by the claimant. However, the Bundesfinanzhof decided that the blocking amount did not terminate in the upstream merger but continued in the new shares. Therefore, the applicability of Sec. 50c ITA to the initial acquisitions is relevant to the decision of the Bundesfinanzhof in the *Glaxo Wellcome* case. This transaction, and not the subsequent steps of the reorganization, raises the question of the compatibility with the fundamental freedoms.

2.4 Court proceedings in Germany and the reference of the Bundesfinanzhof

The Lower Fiscal Court in Munich,[9] to which the claimant appealed first, denied the application of Sec. 50c para. 1 ITA with a somewhat interesting interpretation of the wording. It argued that the question whether the seller is entitled to an imputation credit has to be answered not only from the perspective of the German imputation system, but should also take into consideration whether the seller in his country of residence was entitled to an imputation credit for the corporate income tax. If so, the Court reasoned, there is no need for the application of an anti-avoidance provision like Sec. 50c ITA because there is no tax-driven motivation for realizing the profit earned in the corporation through a sale of shares rather than through distribution.

However, the Bundesfinanzhof did not follow this interpretation, holding that according to the purpose of Sec. 50c ITA to ensure single taxation of corporate profits in Germany, only the entitlement to the German imputation credit is relevant. Instead, the German Federal Fiscal Court (Bundesfinanzhof) questioned the applicability of Sec. 50c ITA on the grounds of the right of establishment (Art. 43 EC) and the free movement of capital (Art. 56 EC) and referred to the European Court of Justice for a preliminary ruling on 23 January 2008.[10]

The question posed to the ECJ reads as follows:

> "Do Article 52 of the EC Treaty (now Article 43 EC) or Article 73b of the EC Treaty (now Article 56 EC) preclude legislation of a Member State which, in the framework of a national system of corporation tax credits, excludes the reduction in the value of shares as a result of profits distribution from the basis

9 Finanzgericht München 10 February 2006, 8 K 5285/02, *EFG* 2006, p. 820.

10 C-182/08, *Glaxo Wellcome*, pending.

> of assessment for that tax when a taxpayer who is entitled to a corporation tax credit has acquired shares in a company which is fully taxable from a shareholder who is not entitled to a tax credit, whereas had the acquisition taken place from a shareholder who was entitled to a tax credit such a reduction in value would have reduced the basis of assessment for the tax of the purchaser?"

2.5 Existing case law

Up to date, the ECJ has not decided on the European law requirements of the treatment of cross-border sales of shares. Nevertheless, the way the Bundesfinanzhof formulated the reference the case shows similarities with the *ACT* and the *Burda*. Whether Germany was allowed to safeguard its imputation system through Sec. 50c ITA depends on the underlying issue whether the imputation system as such had to be extended to non-resident shareholders for reasons of European law.

So far, the ECJ has adjudicated only in favour of an opening of the corporate tax imputation systems to distributions from non-resident corporations (*Verkooijen,*[11] *Lenz,*[12] *Manninen,*[13] *Meilicke*[14]), obliging the countries of residence of the shareholder having imputation systems to grant the credit for dividends paid by non-resident corporations as well.

In the opposite situation of an inbound investment, the ECJ has so far denied that non-resident shareholders are objectively in the same situation as resident shareholders. Therefore, a different tax treatment would not result in discrimination. Only if the Member State in which the distributing company resides imposes a charge to income tax not only on resident shareholders but also on non-resident shareholders in respect of the dividends they receive from a resident corporation, does the ECJ consider the position of those non-resident shareholders comparable to that of resident shareholders.[15] This implies that non-resident shareholders have to be granted an imputation tax credit to the extent their dividends are burdened with a dividend withholding tax in the country of source.

The ECJ's view is based on the source country's entitlement, which follows from the territoriality principle. The principle of territoriality enshrined in international tax law and recognized by Community law is considered to be the basis for a fair allocation of taxing powers among the Member States. The obligation to avoid economic double taxation by crediting the corporate income tax of non-resident shareholders as well would interfere with this principle, because it would

11 ECJ 6 June 2000, C-35/98, *Verkooijen* [2000] ECR I-4071.

12 ECJ 15 July 2004, C-315/02, *Lenz* [2004] ECR I-7063.

13 Infringing the free movement of capital, see C-292/04, *Meilicke* following C-319/02, *Manninen*.

14 Infringing the free movement of capital, see C-292/04, *Meilicke* following C-319/02, *Manninen*.

15 C-374/04, *ACT Group Litigation*, paras. 46–74; similarly C-284/06, *Burda* (not yet published), paras. 81–95.

oblige the country where the distributing corporation resides (the country of source) to abandon its right to tax a profit generated through an economic activity undertaken on its territory. Instead, the ECJ considers the country of residence of the shareholder as primarily obliged to avoid economic double taxation. In this respect the ECJ also refers to Art. 4 of the Parent-Subsidiary Directive (90/435/EC) in accordance with which the Member State of the parent company is required to avoid economic double taxation whilst the Member State of the subsidiary has to refrain from imposing tax on the distribution, but may keep the corporate income tax levied at the subsidiary's level.

Applying the ECJ's view that the exclusion of non-resident shareholders from the imputation tax credit does not lead to discrimination of the non-resident shareholder, the German legislator would be justified in ensuring Germany's (as source country) right to tax the profit earned in a subsidiary also in the event of a sale of the shares instead of a distribution, at least if the transfer of the shares from the non-resident shareholder to the resident shareholder has *only* been undertaken to circumvent the justified denial of the imputation tax credit on distributions to non-resident shareholders. Thus, in the light of the *ACT* and *Burda* cases it seems likely that the ECJ will not hold that there is discrimination.

However, the ECJ's line of argumentation has been criticized by quite a few scholars.[16] It has been challenged on two levels: First, the underlying issue of the preservation of the allocation of the power to impose taxes among the Member States has to be regarded as a question of justification and not as one of objective comparability of resident and non-resident shareholders. If not regarded as a question of discrimination, but of justification, the source country's entitlement based on the territoriality principle would have to meet the proportionality test. Under this condition, it can be argued that the Member State of the distributing corporation is at least responsible in the second degree for preventing economic double taxation if the residence country of the shareholder does not grant relief.

2.6 Observations

2.6.1 Applying the *ACT* and *Burda* rationale

It could be argued that distribution and disposal of shares are just two different ways to achieve the effect of a transfer of profits earned through a corporation to the shareholder level and therefore should also be treated neutrally in cross-border transactions. Hence, the same considerations as in *ACT* and *Burda* should be

[16] Englisch, *Dividendenbesteuerung* (2005) pp. 324 et seq.; Englisch, Aufteilung der Besteuerungsbefugnisse – Ein Rechtfertigungsgrund für eine Einschränkung der EG-Grundfreiheiten?, IFSt-Schrift (2008), p. 132 with footnote 414; Desens, Die Besteuerung des Anteilseigners bei grenzüberschreitenden Gewinnausschüttungen – Überblick und Grundprobleme, *ISTR* 2003, p. 613 (p. 621); Graetz/Warren, Dividend taxation in Europe: When the ECJ makes tax policy, *CMLR* 2007, p. 1577 (p. 1613).

applied. However, regarding the allocation of taxable rights the ECJ does not consider what would be the best allocation in terms of neutrality but only relies on the common international practice. This becomes obvious in the ECJ's case law on the treatment of equity versus debt. Even though the practice in international tax law and in the European directives of allocating the taxing powers for distributions in the one hand and interest in the other hand is far from neutral, the ECJ accepts the tax planning opportunities arising from the discrepancies in treatment, limited only by anti-avoidance considerations. Therefore, in my view the cross-border capital gain of a non-resident shareholder in *Glaxo* does not necessarily have to be handled in the same way as cross-border dividends paid to non-resident shareholders.

2.6.2 Discrimination: Objectively comparable situation

With regard to the applicable fundamental freedom the first question which comes up is whether Sec. 50c ITA is viewed from the perspective of the non-resident seller or the resident acquirer.

Sec. 50c ITA leads to discrimination of the seller as well as of the acquirer. Nevertheless, the non-resident seller is only indirectly affected by Sec. 50c ITA, because he is not liable to tax under this provision. However, non-resident sellers of shares are treated less favourably than resident sellers of shares because the former are only able to sell shares stained with the denial of write downs for distributions received by the acquirer. They therefore have to accept a lower acquisition price. At the same time two (resident) acquirers are treated differently depending on whether they acquire shares from resident or non-resident shareholders. Even though a distribution received by a resident shareholder from a resident company has no direct cross-border impact, he can at least claim that the free movement of capital has been infringed because the disadvantage of the ban of write downs originates from the previous acquisition of the shares from the non-resident seller. Thus, both the acquirer and the seller are able to invoke the fundamental freedoms.

Sec. 50c ITA results only in covert discrimination because a formal distinction is made not on the basis of the taxpayer's nationality but between acquisitions from shareholders who are entitled to the imputation of the corporate income tax and shareholders who are excluded from the credit. This is also true for tax-exempt German corporations. However, in respect of the ECJ's case law a covert discrimination already exists, if "in the large majority of cases" a disadvantage for cross-border transactions arises. Sec. 50c ITA mainly applied to non-resident shareholders.[17]

According to settled ECJ case law in which Arts. 43 and 56 EC are differentiated, from the non-resident seller's perspective it makes a difference whether he

[17] See in this respect the identical situation in ECJ 12 December 2002, C-324/00, *Lankhorst-Hohorst* [2002] ECR I-1179, para. 28.

held a majority or minority shareholding. A more academic question is whether the resident acquirer may also rely on the freedom of establishment. At least the free movement of capital is affected.

However, due to the settled – although questionable – case law of the ECJ the fact that a Member State treats residents and non-residents differently is not per se discriminatory; it is only discriminatory if both are objectively in a comparable situation. This concept of "normative comparability" was developed mainly in the *Schumacker* doctrine[18] in regard to personal and family circumstances but in *ACT* it was also applied to the imputation of corporate income tax,[19] although this has nothing to do with the personal circumstances of the taxpayer which can be taken into account only in his state of residence.

Applied to the non-resident seller, the only reason why he could be considered not being in a comparable situation is that Germany (at least in its double tax treaties) waives the right to tax the foreign shareholder on his capital gains derived from the disposal of shares in a German corporation. This argument is somewhat circular, because Sec. 50c ITA is an indirect attempt to tax the capital gain of a foreign seller.[20] Moreover, it is most striking that from the perspective of the resident acquirer non-comparability cannot be claimed. Acquirers who acquired shares from non-resident sellers are in an objectively comparable situation with acquirers who acquired shares from resident ones, because both are taxed only in Germany, but only the latter is prohibited to write down the shareholding due to distributions received.

2.6.3 Justification

If the ECJ does affirms the comparability it will have to look for a justification and scrutinize whether the measure at issue goes beyond what is necessary to attain the essential part of the objectives pursued.

Again, Sec. 50c ITA can be viewed in two different ways: On the one hand, as an anti-avoidance rule safeguarding the limitation of the imputation credit to dividends paid to domestic shareholders, on the other hand, as part of the system of the taxation of capital gains from shares.

2.6.3.1 Justification as anti-avoidance provision

Even if the conceptual context of Sec. 50c ITA is seen only in the light of the imputation system in regard to distributions, the ECJ may come to a different conclusion from that in *ACT* and *Burda* because the provision is not part of the general imputation system, but is meant to be an anti-avoidance rule to prevent non-resident shareholders from circumventing exclusion from the imputation system.

As demonstrated above, the reason why Sec. 50c ITA cannot be justified as an anti-avoidance rule is not – as the German Federal Fiscal Court held – that the exclusion of foreign shareholders from the imputation system itself causes a violation of the EC Treaty. The prevention of tax avoidance is one of the legitimate objectives consistent with the Treaty and is justified by imperative reasons in the public interest. From this perspective, the German legislator may well safeguard its imputation system against abuse. However, the ECJ applies a narrow concept of tax avoidance. It is part of the canon of settled case law that the mere fact of cross-border activities does not allow for the assumption of tax avoidance. The application of the anti-avoidance provision must be appropriate to ensure the attainment of the objective thus pursued and may not go beyond what is necessary to attain it. To be justified, anti-avoidance rules have to be designed with the specific purpose of preventing wholly artificial arrangements,[21] set up to circumvent Member States' tax legislation in order to obtain tax benefits. The Member States may work with typified avoidance assumptions, but must provide a motive test that allows the taxpayer to prove on a case-by-case basis that the structure at issue has not been chosen entirely for tax reasons but also for good economic reasons.

Sec. 50c ITA meets none of these requirements. Neither is it limited to typical tax avoidance situations. It simply applies to any acquisition of shares from a non-resident shareholder. It is not limited to specified dividend stripping constructions, e.g. rotation models. Nor does the administrative decree R 227d III 2 EStR leads to such a limitation. From the perspective of the taxpayer, a tax advantage can only be pursued if the capital gain is not taxed at all, either in Germany, or in the country of residence of the shareholder. Furthermore, no motive test is provided for to allow the taxpayer to document other than mere tax reasons for the transaction.

2.6.3.2 Justification as indirect capital gains taxation

The line of argument changes if Sec. 50c ITA is understood not as part of the imputation system applicable to avoid economic double taxation in the case of distributions but as a measure to ensure single taxation in the case of the realization of profits earned in a corporation through the sale of the shareholding.

Except in cases of an exit taxation of *resident* shareholders, the ECJ thus far has not decided on the allocation of the power to tax capital gains derived from the sale of shares in a corporation by a *non-resident* shareholder. Imputation systems, as the German system between 1977 and 2001, are generally limited to distributions. Notwithstanding that taxation of capital gains from shares also results in double taxation to the extent they reflect retained earnings of the corporation that have been previously taxed, capital gains are not integrated into the imputation mechanism.

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[18] ECJ 14 February 1995, C-279/93 *Schumacker* [1995] ECR I-225, paras. 32 et seq.; likewise 5 July 2005, C-376/03, *D* [2005] ECR I-5821, para. 27.

[19] C-374/04, *ACT Group Litigation*, para. 60.

[20] Blumers/Witt, Die mittelbare Besteuerung von Anrechnungsberechtigten durch § 50c Abs 11 EStG, *DSTR* 1998, p. 393 (p. 394); contra Siegemund, in Ernst & Young, *KStG mit Nebengesetzen, Commentary* (1997) § 50c para. 7.2.

[21] See ECJ 12 September 2006, C-196/04, *Cadbury Schweppes* [2006] ECR I-7995, para. 55.

Therefore, the findings of *ACT* and *Burda* are at the very least not directly applicable.

First, it seems unlikely that the ECJ will hold that acquirers who acquired shares from non-resident sellers are not in an objectively comparable situation with acquirers who acquired shares from resident ones. Both are taxed only in Germany, but only the latter are prohibited from writing down the shareholding due to distributions received.

Second, if the ECJ reaches the level of examining justifications, it will have to look at Sec. 50c ITA according to any given legitimate objective on the grounds of the proportionality test. There are basically two conceivable reasons for justification which most likely will be put forward by the German Government:

(1) the preservation of the allocation of taxing powers; and
(2) the coherence principle.

If one takes into account the ECJ's case law at present, the German Government will probably not succeed with either one of these justifications. If one classifies Sec. 50c ITA as an indirect attempt to tax the capital gains of non-resident shareholders, this does not preserve the accepted rules of the allocation of taxing powers, but on the contrary interferes with them. Neither the Parent-Subsidiary-Directive, the scope of which is limited to intercompany distributions, nor the tax treaty network contains a predominant power of the source country to tax in the case of realization of profits through a sale of shares. In these cases the Member State, in which the shareholder has his place of residence, has the first right to tax hidden reserves as well as disclosed and previously taxed reserves. If that state does tax the capital gains of the seller, as a result of the ECJ's case law on distributions, the state where *the acquirer* is residing has to apply the relief mechanism on subsequent distributions for avoiding double taxation in the same way as is done where there is an acquisition from a resident shareholder. If economic double taxation is avoided by the taxpayer's right to write down the shareholding in the event of subsequent distributions, this right has to be granted no matter where the capital gain has been taxed.

Neither can the denial of dividend-related write downs be justified by the cohesion of the German tax system, because of the ECJ's narrow understanding of the concept of tax cohesion. There has to be a direct link between the grant of a tax advantage and the offsetting of that advantage by a fiscal levy, both of which relate to the same tax.[22] Such a direct link is negated if the tax advantage and the corresponding disadvantage do not occur at the same taxpayer's expense. This requirement may have to be relaxed in the case of corresponding rules of the corporate income tax system which by nature apply to two different taxpayers, in order to integrate taxation at the corporate level and the shareholder level. However, in the case of Sec. 50c ITA there is no comparable systematical link. The tax treatment of the seller and of the acquirer is not systematically linked, as was shown above.

[22] ECJ 28 January 1992, C-204/90, *Bachmann* [1992] ECR I-249, paras. 21 et seq.; C-319/02 *Manninen*, para. 42.

The only defense that might be partly successful is the aim to avoid a double relief. If the resident country of the seller exempts the capital gain from tax, a subsequent write down of the shares based on the dividends received would result in a double dip and therefore would privilege the cross-border case compared to the mere domestic one, which is not the purpose of EC law. The ECJ might, in accordance with *Marks & Spencer*[23] and *Lidl Belgium*[24] where it introduced the avoidance of double dips as reason for justification, consider Sec. 50c ITA justified to the extent the capital gains are not taxable in the Member State of the seller of the shares. This would allow Germany to make the write down available only under the condition the acquirer can show that the capital gain is taxable in the hands of the seller. Such a precondition would replicate the rule that in 1997 was laid down in Sec. 50c para. 11 ITA for acquisitions from shareholders who are entitled to the imputation tax credit. Thereby, from the standpoint of European law, no distinction may be made regarding where the capital gains are taxable: in Germany or in another Member State.

An interesting question is whether the ECJ will follow the view put forward here on the grounds of the reference question formulated by the Bundesfinanzhof, because it focuses only on the classification of Sec. 50c ITA as a safeguard of the imputation system. Since the ECJ takes the consistent line that the original reference must contain the entire facts and legal framework the reference would have to be amended so as to embed Sec. 50c ITA in the legal context of capital gains taxation.

III. STEKO

3.1 Introduction: transition from the corporate tax imputation system to a classical system with participation exemption

The *STEKO* case concerns a transitional rule between the former corporate tax imputation system and the classical system with participation exemption that was implemented in 2001/2002.

Under the former imputation system, capital gains from shares earned by a corporation were tax exempt if the selling corporation held a minimum participation of at least 10% in a non-resident company. (Sec. 8b CTA 1993[25]). The tax exemption was meant to promote Germany as a holding location. It was accompanied by

[23] ECJ 13 December 2005, C-446/03, *Marks & Spencer* [2005] ECR I-10837, para. 47.
[24] ECJ 15 May 2008, C-414/06, *Lidl Belgium* (not yet published) para. 42.
[25] Implemented by Standortsicherungsgesetz of 13 September 1993, BGBl I 1993, p. 1569.

a ban of loss set off, but the taxpayer was allowed to deductions of reductions in profits in connection with the holding in the non-resident company in the case of a decrease of the value of the shares.

In the course of the move toward the new classical corporate tax system, the participation exemption was introduced as a general rule to prevent economic double taxation at the corporate level on distributions as well as on capital gains from shares. Sec. 8b para. 2 CTA exempts capital gains from shares regardless of any threshold and no matter whether the shareholding is in a resident or a non-resident company. Accordingly, Sec. 8b para. 3 sentence 3 CTA excludes any set off of losses related to the shareholding. Profit reductions from the write downs of the shares are also entirely forbidden.

The provision at issue[26] concerns the first application of the new law. The transition from the imputation credit system to the classical system with shareholder relief entailed a highly sophisticated set of transitional rules, which distinguished between distributions and capital gains. The general underlying rationale was that for distributions in 2001 the former imputation credit was still granted at the shareholder level, whilst after 2001 and for the next 16 years the effect of the former imputation system was limited to the level of the distributing corporation to bring the tax burden down from the former higher tax rate for retained earnings to the lower tax rate for distributed earnings. The first application of the new rules for the taxation of capital gains from shares was linked to the last application of the imputation credit beginning after the expiration of the last fiscal year of the application of the imputation system, thus, in general in 2002.

Therefore, the new version of Sec. 8b paras. 2 and 3 CTA for shareholdings in resident companies applied only from 2002. Only if a resident company had a fiscal year different from the calendar year could the new law have already been applicable in 2001. In contrast, for shareholdings in non-resident companies the new system of capital gains taxation and the related rules for loss set off and write downs already applied from 2001. The time gap reflected the fact that for resident companies the former corporate tax imputation system still partly applied in 2001, whilst non-resident companies had never been integrated in the imputation system.

Thus, in 2001 capital gains from the sale of shares held by a resident company in another resident company were taxable. In exchange, losses from sales and write downs of the value of the shares were still deductible. Capital gains from shares in non-resident corporations were already tax exempt in 2001, without the former minimum holding requirement applying. In exchange, the ban on loss set off and write downs of the value of the shares already applied in 2001, also to participations below 10%.

[26] Former Sec. 34 para. 4 sentence 1 No. 2 CTA, now Sec. 34 para. 7 sentence 1 No. 2 CTA.

3.1 Facts of the case

The facts of the case at hand are simple. STEKO is a German closed company (GmbH) which in 2001 owned less than 10% of the capital in a non-resident company. STEKO was denied write downs of the value of the holding in the foreign company for tax purposes in the year 2001. From the findings of the lower tax court it is not clear whether the non-resident company was an EU company or whether it had its seat in a third country.[27]

3.2 Preliminary question

In the reference made to the ECJ by the Federal Fiscal Court (Bundesfinanzhof),[28] the German court asked whether Art. 56 EC precludes a provision of a Member State according to which the prohibition of the deduction of reductions in profit in connection with the holding of a capital company in another capital company enters into force one year earlier with regard to foreign holdings than with regard to domestic holdings.

3.3 Existing ECJ case law

The *STEKO* case shows significant similarities with the *Grønfeldt* case, decided on 18 December 2007.[29] In *Grønfeldt* the ECJ also had to deal with the provisional system of the German business tax reform 2000. Part of the business tax reform 2000 was a decrease in the threshold for taxable capital gains from shares. Before the reform, capital gains were only taxable if the seller held a share of at least 10% of the share capital of a company within the last five years prior to the sale. This threshold was lowered from at least 10% to at least 1%. Due to a linkage of the application rule of the new threshold with the former corporate tax imputation system, the new threshold in general applied for shareholdings in domestic companies only from 2002 onwards whilst for the sale of shareholdings in foreign companies the new threshold already applied in 2001.

The ECJ considered the earlier application of the lowered threshold to shareholdings in foreign companies an infringement of the free movement of capital. Despite its short period of application, such a difference in treatment could have the effect of an obstacle to raise capital in Germany for foreign companies. The ECJ took a narrow approach, looking only at the year 2001, in which the situation of shareholders with shares in non-resident companies was disadvantageous compared with shareholders with shares in resident companies. It refused to take into consideration that the change as a whole might have been favourable to shareholders in non-resident companies.

[27] Finanzgericht Rheinland-Pfalz 29 September 2005, 6 K 2727/04, *EFG* 2006, pp. 1696 et seq.
[28] BFH 4 April 2007, I-R 57/08, BStBl. II 2007, pp. 945 et seq.
[29] See ECJ 18 December 2007, C-436/06, *Grønfeldt* [2007] ECR I-12357.

The ECJ also refused to concede the Member States greater discretion in the transition to and alignment of their national tax systems with the requirements of the EC law.[30] Like any other rule, a transitional rule as part of a provisional system must comply with the fundamental freedoms. This is consistent with the consistent line of the ECJ that discriminations and restrictions are prohibited even if they are of limited scope or minor importance.[31] The extent of the disadvantage influences the proportionality test but still has to be justified. Indeed, it is hard to think of a reason why the transitional rules of a reform that is meant to abolish a system which is not in line with EC law should be allowed to create new inconsistencies with EC law. The ECJ, unlike the German Constitutional Court, should be applauded for not enlarging the discretion the reform legislator or absolve it from the obligation to justify the different treatment by a transitional system.

Finally, the ECJ denied the justification based on the coherence of the transitional system.[32] The fact that shareholders with shares in non-resident companies were already entitled to the 50%-income-reduction procedure in 2002 could not justify the earlier application of the lower threshold because there was no direct link between the threshold and the treatment of the capital gain. The ECJ understood that concerning the aim of full taxation application of the new system for capital gains of shares in domestic corporations could be made applicable only from 2002 onwards because in 2001 the former imputation system at the shareholder level still applied. The imputation system was not available for distributions from foreign companies. However, this does not put shareholders with shares in resident and shares in non-resident companies in regard to the threshold in an objectively different situation.

3.4 Observations

The reference at hand is somehow symbolic for an institutional problem. It deals with a very peculiar constellation of a transitional rule effective only in 2001/2002, with little relevance beyond the reform procedure at that time. Furthermore, the question is already answered to great extent in the *Grønfeldt* decision. Nevertheless, on the grounds of the *CILFIT* decision[33] the Bundesfinanzhof took the position that the answer of Community law was not so clear that it could refrain from referring to the ECJ. It is questionable to tie up the Court's capacity with references like the one at hand. However, German tax courts are reluctant to decide without reference to the ECJ simply by transferring existing case law on the interpretation of the Treaty applying the rule of primacy of EC law over the law

[30] C-436/06, *Grønfeldt*, paras. 32–33.

[31] See ECJ 15 February 2000, C-34/98, *Commission v. France* [2000] ECR I-995, para. 49; 11 March 2004, C-9/02, *de Lasteyrie du Saillant* [2004] ECR I-2409, para. 43.

[32] C-436/06, *Grønfeldt*, paras. 27–31.

[33] ECJ 6 October 1982, Case 283/81, *CILFIT* [1982] ECR 3415.

of the Member States. Of course, there will rarely be a situation of provisions that are as alike as two peas in a pod. Thus, the national courts can always find a reason for the necessity of a reference. However, in regard to *STEKO* the Bundesfinanzhof is not really to blame, because the reference was made before the *Grønfeldt* judgment was handed down.

This leads to the question whether one can expect any new insights from the *STEKO* case. The possible justifications considered in the reference by the Bundesfinanzhof have been discussed and refused in the *Grønfeldt*. A change in the argumentation is unlikely.

However, the coherence argument in *STEKO* is slightly different from the *Grønfeldt* case. The exclusion of any loss and write down of shares in principle is viewed as the logical consequence of the participation exemption for capital gains from shares. Capital gains from the disposal of shares in a resident company in 2001 were still fully taxable. Thus, in return, decreases in value must have been tax effective. Thus, there was a reason of coherence for the different timing of the ban on the deduction of reductions in profits of shareholding in resident and non-resident companies. Unlike the relation between the threshold for the taxation of capital gains from shares and the 50% income reduction procedure in *Grønfeldt*, this is a direct link. However, the German legislator itself had questioned this direct link in the past, because even though capital gains from shares in non-resident companies had already been tax exempt since 1994. Sec 8b para. 2 sentence 2 CTA in the version of the Standortsicherungsgesetz of 13 September 1993[34] explicitly allowed the deduction of losses. And even if the loss deduction was excluded in 1999, the deduction of reductions in profit due to a decrease of the value of the shares was still possible. Therefore, it seems unlikely that the ECJ will hold the different treatment justified on the grounds of the coherence principle.

One noteworthy aspect of the *STEKO* reference is that from the facts ascertained by the lower tax court it is not known whether the shares were held in an EU company or a company in a non-member country.

According to the ECJ's settled case law, as the share amounted to less than 10% of the capital of the foreign company it does not fall not within the scope of Art. 43 EC, because Sec. 8b CTA does not "[relate] to holdings giving the holder a definite influence on the decisions of the company concerned and allowing him to determine its activities come within the material scope of the Treaty provisions on freedom of establishment".[35] Therefore, the relation between the freedom of settlement and the free movement of capital is not at issue.

The only remaining question is whether – in case the company in which the shares were held, indeed resided in a third country – additional grounds of justi-

[34] Federal Law Gazette I 1993, p. 1569.

[35] ECJ 10 May 2007, C-492/04, *Lasertec* [2007] ECR I-3775, paras. 19 and 25; see also C-196/04, *Cadbury Schweppes*, para. 31; C-524/04, *Thin Cap Group Litigation*, para. 27.

fication apply. In the recent *A*[36] decision the ECJ advanced its case law on the application of Art. 56 to third country cases, especially in regard to Art. 57 EC, which in the case at hand is of no relevance because it covers only provisions which came into force before 1 January 1994. However, beyond Art. 57 EC, the ECJ has acknowledged that the movement of capital to or from third countries takes place in a different legal context from that which occurs within the Community. Therefore, it may be that a Member State will be able to demonstrate that a restriction on the movement of capital to or from third countries is justified for a particular reason in circumstances where that reason would not constitute a valid justification for a restriction on capital movements between Member States.[37] A different treatment in regard to third countries can be justified in particular by the need to guarantee the effectiveness of fiscal supervision. With regard to a third country Member States do not have recourse to the mutual assistance between competent authorities provided for by Directive 77/799/EEC.

In the *STEKO* case the ECJ will get the opportunity to hold on whether disregarding the deduction of reductions in profits related to shares in foreign companies can be justified in regard to difficulties in getting the necessary information on the development of the value of the shares. The referring Senate of the Bundesfinanzhof questioned this justification at least in the case of shares of listed companies because a decrease in the value of the shares can be easily seen from the published performance of the share. Furthermore, write downs of shares in third-country companies were permitted prior to 2001. Sec. 8b CTA in its version before the business tax reform 2000 was not limited to shareholdings in EU companies. This permits the conclusion that the German legislator apparently had no concerns about verification. And, finally, the total exemption of write downs merely for reasons of the effectiveness of the fiscal control would be disproportionate because under Sec. 90 para. 2 of the General Tax Code the taxpayer has enhanced documentation duties in cross-border cases. In addition, the legislator could have included a reversal of the burden of proof,[38] which also would have been less burdensome than the total ban of write downs.

IV. Ernst & Young

4.1 Introduction

For years the German Reorganization Tax Act has been criticized for not fulfilling the requirements of the Merger Directive and for violating the freedom of establishment. Finally, the adoption of the Council Regulation on the Statute for a

36 ECJ 18 December 2007, C-101/05, *A* [2007] ECR I-11531.
37 C-101/05, *A*, para. 37; ECJ 12 December 2006, C-446/04, *FII Group Litigation* [2006] ECR I-11753, para. 171.
38 C-101/05, *A*, para. 57.

European Company[39] with the subsequent amendment of the Merger Directive and the ECJ decision in the *SEVIC* case[40] led the German legislator to become active. Effective from 1 January 2006 the German Reorganization Tax Act has been – as the legislator called it –"Europeanized" in order to achieve an alignment of the German rules with current EU corporate and tax law.[41] If and to what extent the reform eliminated the infringements of the Merger Directive and primary EC law or whether it may even have caused new EC law problems is yet not clear.[42]

The changes are quite fundamental. First of all, the legislator adopted a general exit tax in the Income Tax Act on all assets transferred abroad on the basis of the current fair market value if the German right to tax the capital gain from the disposal of such an asset is lost or limited because of the transfer. In the case of a transfer of an asset to a foreign permanent establishment or a transfer of a company's seat the taxpayer may apply for a deferral under certain limited conditions. This exit tax rule, in conflict with the legislator's intentions causes a new infringement of the freedom of establishment.[43]

Regarding the taxation of reorganizations, the scope of the German Reorganization Tax Act, which formerly was applicable only to domestic reorganizations, was extended to EU entities, but not to third-country entities. The legislator could not be convinced of the need for a globalization of the Reorganization Tax Act even though tax neutrality is granted only under the condition that the German right to tax the hidden reserves is neither excluded nor limited. The concept of anti-avoidance rules (former Secs. 21 and 26 Reorganization Tax Act) was changed to be brought in line with the requirements of Art. 11 of the Merger Directive. Furthermore, the legislator abolished the former transfer of loss carry-forwards which were previously allowed under certain conditions. This alteration was justified by the legislator to prevent the obligation of taking into account foreign losses in cross-border reorganizations but it was detrimental to the conditions of domestic reorganizations, too.

4.2 Relevant German legislation

The *Ernst & Young* case involves the (now) abolished rules of the "double book value carryover" ("doppelte Buchwertverknüpfung") of the former Reorganization

39 Council Regulation (EC) No. 2157/2001 of 8 October 2001 on the Statute for a European company (SE), OJ No. L 294/1.
40 ECJ 13 December 2005, C-411/03, *SEVIC Systems* [2005] ECR I-10805.
41 Gesetz über steuerliche Begleitmaßnahmen zur Einführung der Europäischen Gesellschaft und zur Änderung weiterer steuerrechtlicher Vorschriften (SEStEG) of 7 December 2006, BGBl. I 2006, p. 2782.
42 Regarding the EC aspects of the reform, see for example: Schwenke, Europarechtliche Vorgaben und deren Umsetzung durch das SEStEG, *DSTZ* 2007, p. 235; Hörtnagel, Europäisierung des Umwandlungssteuerrechts – SEStEG, *STBG* 2006, p. 471; Körner, Europarecht und Umwandlungssteuerrecht, *ISTR* 2006, p. 109.
43 See Hey, in Tipke/Lang, *Steuerrecht*[19] (2008) § 17, para. 239 with further references.

Tax Act. Until 2006, contributions in kind in corporations in return for newly issued shares were in principle tax-neutral only if the receiving company entered the shares at book value. That is because under Sec. 20 para. 4 of the Reorganization Tax Act the value at which the receiving company entered the shares transferred on its books represents the transferring company's sales price and the acquisition costs for the new shares in the receiving company. Sec. 23 para. 4 of the Reorganization Tax Act also made this rule applicable to contributions in kind in an EU corporation. The condition of the „double book value carryover" was equally applicable to domestic and cross-border contributions. However, in cross-border situations the tax neutrality depended on whether the country in which the receiving company was resident provided for a continuance of the book value; usually this is not the case.

4.3 The German court proceedings and the reference questions

In its well-reasoned decision of 17 February 2005 the Tax Court of Baden-Württemberg[44] took the position that the „double book value carryover" is not compatible with Art. 8 paras. 1 and 2 of the Merger Directive and that by direct application of the Directive the claimant was able to make a tax-neutral contribution at book value regardless of the valuation at the level of the receiving company. A reference to the ECJ was not held necessary because of the clear and unambiguous wording of the Directive.

The Bundesfinanzhof rejected the notion of direct application of the lower tax court and held that the Merger Directive allowed some leeway as to how the Member States transformed it into their national law. Furthermore, the Bundesfinanzhof did not consider the wording of Art. 8 paras. 1 and 2 of the Merger Directive as clear as the lower tax court did.

In its reference to the ECJ the Bundesfinanzhof seeks to know whether Art. 8 paras. 1 and 2 of the Merger Directive (Directive 90/434/EEC)[45] preclude legislation of a Member State which in the case of a contribution in kind by an EU company in another EU company allows the transferring company the continuation of the book values only under the condition that the receiving company for its part enters the received shares into its accounts at book value.

If this is denied, the Bundesfinanzhof has asked whether the German legislation violates Arts. 43 and/or 56 EC, albeit the „double book value carryover" is also required to achieve tax neutrality in the case of a contribution in kind in a resident company.

In the oral pleadings the Commission took the position that Art. 8 of the Merger Directive must be read in such a way that the „double book value carryover" contravenes with the directive's intentions.

[44] 6 K 209/02, *ISTR* 2005, p. 278.

[45] Directive 90/434 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States.

4.4 Observations

The first reference question regards the interpretation of the Merger Directive as well as its direct applicability.

In line with most authors, the referring court reads Art. 8 para. 1 as a general rule precluding any taxation of the allotment of securities representing the capital of the receiving company to a shareholder of the transferring company in exchange for securities representing the capital of the latter in the event of mergers, divisions or exchanges of shares. The Merger Directive does not force the Member States to waive their right to tax hidden reserves in connection with mergers, divisions, transfers of assets or exchanges of shares but is aiming at a tax deferral of the taxation of the capital gains relating to the transferred assets until their disposal.[46] This purpose is the guideline for interpretation of the Directive's provisions.

The only precondition for granting tax neutrality the Member States may set is laid down in para. 2 of Art. 8 of the Merger Directive. Pursuant to this provision, the shareholders may not attribute to the securities received a value for tax purposes higher than the one the securities exchanged had immediately before the merger. Any other restrictions are precluded. In particular, Art. 8 of the Merger Directive does not contain any further requirements on the valuation at the level of the receiving company. The language of the Directive – using the word "shareholder" in the singular instead of "shareholders" – does not allow an interpretation covering the valuation at the transferring *and* receiving company. Also, with regard to the purpose of the Merger Directive the silence of Art. 8 on the valuation at the receiving company cannot be interpreted in a way that allows the Member States discretion to set additional requirements for the receiving company. From the perspective of the country where the transferring company has its seat, additional requirements for the valuation at the level of the receiving company which has its seat in another Member State simply do not make sense and are contradictory to the Directive's intentions. There is no point in ensuring the taxation in another Member State by setting additional requirements for the tax neutrality of the contribution. Such additional requirements are not justified for anti-avoidance purposes either, since Sec. 26 para. 2 of the former Reorganization Tax Act, which was meant to implement Art. 11 of the Merger Directive into national law, contained an exhaustive anti-avoidance rule.

In also applying the principle of authority (Maßgeblichkeitsprinzip) of the tax values, which was the underlying rationale of the former German reorganization taxation, to cross-border cases, the German legislator limited the tax neutrality by a concept which is not commonly known in the EU. Therefore, the „double book value carryover" was not only an additional requirement the receiving company had to fulfil but in most cases could not be satisfied because in many other EU

[46] See preamble to Directive 90/434/EEC.

Member States capital gains of shares are tax exempt and therefore a concept of tax book value at the receiving company does not exist. In these cases the possibility of a tax neutral exchange of securities in fact was an idle hope.[47]

Furthermore, the double book value requirement results in a duplication of the hidden reserves, causing double taxation if the capital gain was actually taxed in the country of the receiving company. In a purely domestic situation the relief of the former corporate imputation system was available to avoid economic double taxation but in contributions into foreign corporations double taxation occurred. At least prior to the *Meilicke* decision[48] no imputation credit was granted for distributions of non-resident companies.

Nevertheless – and different from the lower tax court – the referring Senate of the Bundesfinanzhof did consider Art. 8 para. 2 sentence 1 of the Merger Directive as not sufficiently clear and unconditional that the claimant could invoke direct application of the Directive. In my view, the point at issue was not the exceptional direct application of the Directive, but its correct interpretation.

With the second question the court indirectly asks whether the requirements of the fundamental freedoms can go beyond secondary Community law. If Art. 8 paras. 1 and 2 of the Merger Directive do not prevent the Member States from setting additional criteria for the tax neutrality of the contribution, the question arises whether such criteria would infringe the free movement of capital or the freedom of establishment.

Application of either Art. 43 or 56 EC would depend on whether the transferred shares allow control. However, it is unclear whether the „double book value carry-over“ causes discrimination at all since it applies to domestic and EU contributions equally. It could only constitute covert discrimination. But even this is questionable because it does not relate to any criterion that indirectly applies mostly to cross-border contributions. Nevertheless, even applied equally it has a discriminatory effect for two reasons, an effect which in the majority of cases arises only for cross-border transactions.[49] First, the requirement of valuation at book value at the level of the receiving company in most cases, where the receiving company has its seat in another Member State, cannot be met. Hence, the tax neutrality of cross-border contributions in kind usually was not available. Second, even if the book value requirement was fulfilled, the duplication of the hidden reserves in cross-border cases resulted in economic double taxation which was a reflection of the previously domestically limited corporate tax imputation system. Therefore, the ECJ may well conclude that cross-border contributions were treated less favourably.

47 See Finanzgericht Baden-Württemberg of 17 February 2005, 6 K 209/02, *ISTR* 2005, p. 278 (p. 280); Rehm/Nagler, GmbH-Kommentar, *GmbHR* 2007, p. 830.

48 C-292/04, *Meilicke*.

49 See ECJ 26 October 1999, C-294/97, *Eurowings* [1999] ECR I-7447, para. 36.

A justification of the discrimination is not in sight. As stated above, a justification based on anti-abuse measure fails. Neither can Germany claim an interest in ensuring taxation of a subsequent sale of the shares by the residence state of the receiving company.

V. Krankenheim Ruhesitz

5.1 Introduction

Since the ECJ's decision in the *Lidl Belgium* case[50] in May 2008, we know that in its view in the case of a permanent establishment as well there is no obligation to offset tax-exempt foreign losses immediately in the year they incur, but only as an *ultima ratio* if they can no longer be utilized in the country of source.

Even before the *Lidl Belgium* decision was issued, the Bundesfinanzhof had referred another case concerning the treatment of losses from a foreign permanent establishment under the exemption method. The *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH* case does not concern the deductibility of foreign tax-exempt losses as such, because at that time German tax law provided for a deduction of foreign losses under the condition that, if the foreign permanent establishment made profits in subsequent years, the deducted amount was added back. This is even more than the ECJ required in *Marks & Spencer*[51] and *Lidl Belgium*[52]. Instead, the central question the Bundesfinanzhof asks is under which conditions Germany was allowed to levy a recapture tax.

This reference also concerns law that is no longer in force, because in 1999 Germany abolished Sec. 2a para. 3 ITA, which allowed the deduction of foreign losses. The main reason for the change was budget concerns. Furthermore, it was said that the recapture tax was difficult to enforce and could easily have been circumvented. After the ECJ upheld the present legislation in *Lidl Belgium* it is not likely that Germany will reinvent a rule for the immediate offsetting of foreign losses. However, even after the abolishment of the loss deduction the corresponding recapture rules find application without any limits (Sec. 52 para. 3 sentence 3 ITA[53]). Therefore, the ECJ's decision will have an impact in future years as well. Furthermore, the reference is not only of historical interest, because countries like Austria[54] which still allow a deduction of foreign losses apply similar recapture rules.

50 C-414/06, *Lidl Belgium*.

51 C-446/03, *Marks & Spencer*, para. 55.

52 C-414/06, *Lidl Belgium*, para. 47.

53 An initial limitation of the application of the add-back provision to 2008 was abolished with Jahressteuergesetz 2008 of 20 December 2007 because of the still high unrecovered loss set-offs, see Federal Law Gazette, BGBl I 2007, p. 3150.

54 In Sec. 9 para. 6 no. 6 sentence 2 of the Austrian Corporate Income Tax Act previous foreign losses are added back in taxable years when they were or could have been offset with foreign profits.

5.2 Relevant German legislation

Due to Germany's general international tax policy in its double tax treaties, income from foreign permanent establishments in general is tax exempt in Germany. According to constant case law of the Bundesfinanzhof, the exemption in the double tax treaties has to be interpreted in such a way that it covers profits as well as losses.[55]

In 1969 the German legislator implemented an exception to this general principle, allowing the deduction of losses from foreign permanent establishments to stimulate investments abroad. Sec. 2 para. 1 of the German Foreign Investment Act (Auslandsinvestitionsgesetz), which in 1990 was converted into Sec. 2a para. 3 ITA, provided that a German resident taxpayer, under application of the exemption method, could also deduct a loss incurred by a permanent establishment in another Member State to the extent to which it exceeded the tax-exempt profits made by the permanent establishment. If and insofar as the permanent establishment made a profit in subsequent years with the effect that the exempted income from this Member State was positive, the deducted amount had to be recaptured. However, if the taxpayer could prove that under the law of the source country a deduction of the loss in other years could not generally be claimed, the recapture tax did not take place. The wording of this exception of the add-back was interpreted narrowly. Therefore, it applied only if the loss could not be deducted due to a generally applicable restriction, and not only in the special circumstances of the case at issue. Because of the explicit wording of the statute there was no possibility of a different interpretation under EC law.

5.3 Facts of the case

Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH was a German company which ran a permanent establishment in Austria between the years 1982 and 1994. Until 1990 the activities in Austria generated losses of about DEM 2.5 million. On request of the claimant these losses were offset in Germany. Between 1991 and 1994, the permanent establishment earned a profit of around DEM 1.2 million.

Up to 1988 the Austrian national tax legislation did not allow a loss carry forward in the case of a non-resident company. Only in 1989 did Austria adopt a loss carry-forward for permanent establishments as well, including all losses incurred in the last seven years prior to 1989. However, the loss carry-forward applied only if the loss could not be offset in the country of the head office.

Since between 1982 and 1990 the claimant had sufficient positive income in Germany to offset the losses from the Austrian permanent establishment, Austria denied the loss deduction. The audit report for 1990–1992, made by the Austrian

[55] BFH 13 November 2002, I-R 13/02, BStBl II 2003, p. 795.

tax authorities, stated that in the case at hand a loss deduction was possible in general, but was denied because of the special circumstances of the case.

Hence, the German tax authorities included the profits of the Austrian permanent establishment earned in the years 1991–1994 in the German tax base with the effect of a recapture of the formerly deducted losses.

The case has the peculiarity that the losses occurred in an Austrian permanent establishment at a time before Austria joined the European Community. Therefore, the case is governed by EEA law with a reference to the fundamental freedoms in the EC Treaty. Even more interesting is that in 1990, at the time the losses at issue occurred, Austria was neither a member of the Community nor of the EEA Agreement. However, in the year 1994 when the recapture tax was levied, Austria had joined the EEA.

5.4 Preliminary questions

The *Krankenheim Ruhesitz* case raises two interesting questions. Firstly, it calls for further substantiation of the conditions of the *ultima ratio* loss acknowledgment by the country of residence as pointed to in *Marks & Spencer* and *Lidl Belgium*, but not yet further elaborated on in those cases.[56] Secondly, the very fundamental issue is brought up whether discriminatory rules of one Member State can be justified because of a primary responsibility of the other Member State to avoid disadvantages for cross-border cases.

With regard to the first issue the Bundesfinanzhof formulated a graduated reference question as following: First, whether the country of residence is allowed to add back previously deducted losses with the exception that the add back will not apply if the taxpayer can prove that according to the provisions of the other Member State applicable to him, it is "in general" not possible to claim a deduction of losses in a year other than that in which the losses were incurred, independently of his individual circumstances. Secondly, if the ECJ should answers this question in the affirmative, whether the state of residence must refrain from retroactive recovery of tax on losses incurred by a permanent establishment situated in another Member State, to the extent to which those losses cannot otherwise be deducted in any other Member State on the ground that the permanent establishment in that other Member State has been disposed of.

5.5 Observations

In my view, the question whether the residence country may apply a recapture tax after initial loss deduction has to be answered in the same light as the *ultima ratio* loss deduction the ECJ requires.

[56] See criticism by Kessler/Eicke, Gedanken zur grenzüberschreitenden Verlustverrechnung nach Lidl Belgium, *ISTR* 2008, p. 581 (pp. 583 et seq.).

First of all, the design of the add-back provision in Sec. 2a para. 3 sentences 3 and 4 ITA results in a disadvantage compared with losses that have been incurred in a German permanent establishment. Even though at first the deduction of the losses has been allowed in the same way as in a domestic permanent establishment, the add-back, regardless of the actual deduction of the losses in the source country, puts the taxpayer with a foreign permanent establishment in a less favourable position than if the latter were to be established in Germany. Only in the matter of timing is there a difference with the provision which was at issue in *Lidl Belgium*, but this still could discourage a taxpayer from carrying on his business through a permanent establishment in another Member State.

Therefore, the restrictions to the exception from the add-back have to be justified. The fact that a Member State overachieves its duties by allowing for an immediate offset of losses does not change the over-all result that has to be achieved to meet the standards the ECJ set out in *Marks & Spencer* and *Lidl Belgium*. Thus, in principle a recapture tax is prohibited if losses cannot be utilized anywhere else. For this reason in order for a recapture provision to be in line with the fundamental freedoms it may not only rely on the fact that the permanent establishment generates profits after the loss period but must also depend on whether the loss can be carried forward in the source country or utilized elsewhere.

In general, the German recapture provision did fulfill these requirements. The only question – which was not discussed in *Marks & Spencer* and *Lidl Belgium* – is whether the *ultima ratio* obligation of foreign loss deduction only applies to general restrictions in the source country or also to situations where because of the special circumstances of the case the actual taxpayer was not able to utilize his loss elsewhere. The ECJ in general takes an individualized approach looking at the actual situation of the single taxpayer. From the perspective of the taxpayer it does not make any difference why the loss deduction in the source country is denied. A case-by-case approach would also parallel the practice on anti-avoidance provisions which deem certain actions to be the circumvention of the tax law. In this realm as well the ECJ requires a case-by-case motive test, assuring that the individual circumstances of the case are taken into account.[57]

Nevertheless, the investigation of the actual offset of the losses in the source country would require a greater exchange of information. The Member States cannot invoke difficulties of control because they will be referred to the Mutual Assistance Directive.[58]

Even more interesting is the second consideration of the Bundesfinanzhof on whether Germany is justified in adding back the previously deducted losses because the restrictions of the loss deduction in the source country Austria themselves infringed the Treaty. Austria did not in general deny a deduction of losses

57 C-196/04, *Cadbury Schweppes*, para. 70.

58 ECJ 15 May 1997, C-250/95, *Futura Singer* [1997] ECR I-2471, para. 41; 28 October 1999, C-55/98, *Vestergaard* [1999] ECR I-7641, paras. 26 and 28.

but only of losses of permanent establishments of non-resident taxpayers. This raises the question of the corresponding responsibilities of the Member States. It shows that tax cases actually are triangular cases, for which the ECJ procedure has no real answer. The ECJ will be deciding on the interpretation of the Treaty in regard to the German provision referred to, and not in regard to the Austrian provision to which indirect reference is made. From a procedural point of view in cases like the one at hand the lack of an instrument of third-party notice appears to be a defect in the ECJ's procedural law.

In 1989 when Austria extended the loss deduction to losses from foreign permanent establishments the infringement was only mitigated but not resolved because of the condition that the deduction of losses, which occurred prior to 1989, was only granted if losses could not be utilized in the country of residence. From the ECJ's understanding as outlined in *Marks & Spencer* and *Lidl Belgium*[59] this reservation is not consistent with the primary obligation of the source country, which because it taxes the profits also has to provide for loss relief.[60] As a matter of symmetry between the right to tax profits and the right to deduct losses, the source country has to allow the deduction of losses generated in a permanent establishment with subsequent profits in the same way than it is granted in a purely domestic case. Indirectly, this also follows from *Futura Singer* in which the ECJ inferred from the fiscal principle of territoriality that for the purpose of calculating the basis of assessment for non-resident taxpayers (only) profits and losses arising from the activities in the source country may been taken into account.[61] In *Deutsche Shell*[62] the ECJ repeated that the residence state cannot be obliged to take into account negative results of a permanent establishment located in another Member State solely because they will not be recognized in that state.

But can Germany claim that because of the infringement of the other Member State involved it does not have to grant loss deduction even though losses ultimately will not be deducted, either in the state of source or in the state of residence?

The condition that the recapture taxation will not apply only if the loss deduction in the country of source failed because of a *general* legal position and not because of the circumstances of the single case at hand is not limited to cases in which the source country denies the loss deduction in a way that infringes EC law. This makes it questionable whether Germany can claim that it is justified in combating infringements of European law by the source country.

59 C-414/06, *Lidl Belgium*, para. 33.

60 Rehm/Nagler, Ausgewählte Schwerpunkte des aktuellen EU-Steuerrechts in der GmbH-Beratungspraxis, *GmbHR* 2008, p. 11 (p. 16); with regard to the recognition of *foreign* losses in the source country, see Wimpissinger, Berücksichtigung ausländischer Verluste im Quellenstaat nach Gemeinschaftsrecht, *SWI* 2006, p. 407.

61 C-250/95, *Futura Singer*, paras. 21–23.

62 ECJ 28 February 2008, C-293/06, *Deutsche Shell* (not yet published), para. 42.

However, if it ere restricted in this way, to compel Germany to grant the loss deduction even though this would be incumbent upon Austria would interfere with the allocation of taxing powers among the Member States in accordance with considerations of inter-nation equity.

In his Opinion in the *Cadbury Schweppes* case Advocate General Leger discussed whether discriminatory or restrictive provisions, e.g. CFC legislation, can be justified if they are supposed to combat unfair tax competition of another Member State.[63] He took the position that the fact that the tax system of the other state may be classified as State aid incompatible with the common market does not alter the assessment of discriminatory rules. It is not the Member State's business to ensure that other Member States fulfill their Treaty obligations. The Treaty contains specific provisions, in Arts. 87 and 88 EC, intended to check the compatibility of State aid measures with the common market and to eliminate its harmful effects on that market. The fact that a tax system does not comply with the rules of the Treaty cannot therefore entitle a Member State to take unilateral measures intended to counter its effects by limiting the freedom of movement.

This could lead to the conclusion that the discriminatory behaviour of another Member State does not function to justify a Member State's own discriminatory measures. However, in my view, the case at hand has to be considered differently. If the reason for justification is the preservation of the allocation of taxing powers the duties of the other Member State cannot be ignored. Otherwise, the allocation of taxing powers would arbitrarily depend on where the taxpayer first files a claim. Furthermore, this would provoke infringement procedures among the Member States pursuant to Art. 227 EC, because there would be no defense against being made accountable for discrimination that conflicts with the fair allocation of taxing powers.

Nevertheless, it is not clear whether the ECJ will hold on this issue at all, because at the time the loss occurred Austria was not bound by Community law because it was not even a member of the EEA. One could take the position that the moment of incurring losses is the relevant one[64] and therefore even after it joined the EEA Austria was not obliged to include losses from pre-Community times in the later alignment of its law to the requirements of the EEA freedoms. Contra, one could argue that the year of the actual loss deduction is relevant. In 1994, when the German recapture tax applied, Austria was bound by Art. 31 of the EEA Agreement which can be read in such a way that permanent establishments with a headquarters in another Member State have to be granted the same loss carry forward as domestic permanent establishments regardless when the loss occurred.

[63] Opinion of Advocate General Leger of 2 May 2006 on C-196/04, *Cadbury Schweppes*, para. 58.
[64] See Rehm/Nagler, *GmbHR* 2008, p. 11 (p. 16).

Greece: The Commission v. Greece Case

Theodore Fortsakis/Katerina Perrou

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Preface

The European Court of Justice is a driving force in the field of direct tax harmonization. Cases pending at the ECJ are therefore very carefully analysed by both academics and practitioners.

On 25–27 September 2008, we organized a conference to discuss the cases now pending before the ECJ in connection with the fundamental freedoms and direct taxation. The possible consequences of future ECJ decisions were also considered. A great number of leading experts on European tax law accepted our invitation to attend the conference. This book contains the results of the conference.

Without the support of the Wolfgang Gassner Research Fund for International Tax Law, the Austrian Branch of the International Fiscal Association (IFA), and the City of Vienna, the conference and the entire project itself would not have been possible.

We are very grateful to the authors, who not only gave us impressive presentations on the pending cases but who also committed themselves to an extremely ambitious schedule and participated in the discussions at the conference with considerable enthusiasm.

Again, we would like to express our sincere thanks for the co-operation and swift realization of this publication project to the publisher Linde, who generously agreed to include the book in its catalogue.

Our particular thanks go to Renée Pestuka for the smooth organization of the conference, to Margaret Nettinga, who greatly contributed by editing and polishing the texts of the authors and to Lisa Paterno who supported us in deciding on the structure of the conference and did essential work in the preparation and publication of this book.

Vienna, October 2008

Michael Lang *Pasquale Pistone* *Josef Schuch* *Claus Staringer*

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