OPINION OF ADVOCATE GENERAL SHARPSTON

delivered on 14 February 2008 [1]

1. In the present case the Bundesfinanzhof (Federal Finance Court), Germany, has asked the Court whether it is compatible with Articles 43 and 56 EC for a German company with income from industrial or commercial activities to be precluded, when calculating its profits, from deducting losses from a permanent establishment in another Member State on the ground that, according to the applicable double taxation convention, the corresponding income from such a permanent establishment is not subject to taxation in Germany.

Background to the main proceedings

2. Under the double taxation convention between Germany and Luxembourg ('the DTC'), [2] profits made by the permanent establishment in one State of a company resident in the other State are subject to tax in the former State. Where the company is resident in Germany, income subject to tax in Luxembourg is to be excluded from its taxable income in Germany. The Bundesfinanzhof indicates that it has interpreted that provision to mean that losses as well as profits made by a permanent establishment in Luxembourg are excluded from the German company's taxable income. I will refer to the DTC as so interpreted as 'the contested measure'.

3. Lidl Belgium GmbH & Co. KG ('Lidl'), established in Germany, carried out its business activities through, inter alia, a permanent establishment situated in Luxembourg. In 1999, the financial year in dispute, Lidl incurred a loss from that establishment in the sum of DEM 163 382 (EUR 83 536), which it initially deducted in calculating its total income. The Finanzamt (Tax Office)

1 — Original language: English.

2 — Convention between the Grand Duchy of Luxembourg and the Federal Republic of Germany for the avoidance of double taxation and relating to mutual administrative and legal assistance in the fields of taxation of income and capital and of business and land taxation, signed in Luxembourg on 23 August 1958 (BGBl. 1959 II, p. 1270).

refused to allow the deduction. The matter came before the Bundesfinanzhof, which has referred the question set out above.

4. Written observations have been submitted by Lidl, the Finnish, French, German, Greek, Netherlands, Swedish and the United Kingdom Governments and the Commission. All those parties, with the exception of the United Kingdom but with the addition of the Finanzamt, were represented at the hearing.

Analysis

5. All those submitting observations concur that Article 43 EC (freedom of establishment) is the relevant provision, so that (on the basis of consistent case-law of the Court) Article 56 EC (free movement of capital) is irrelevant. [3] I agree.

6. I also agree with Lidl and the Commission that it is prima facie contrary to Article 43 EC for a company established in one Member State to be precluded, when calculating its profits, from deducting losses from a permanent establishment in another Member State on the ground that, according to the applicable double taxation convention, the corresponding income from such a permanent establishment is not subject to taxation in the first Member State.

7. Although France, Germany, the Netherlands and Sweden submit that there is no infringement of Article 43 EC, I cannot share that view. A German company with a permanent establishment in Luxembourg which has made a loss is manifestly treated less favourably than a German company with a domestic permanent establishment which has made a loss: in the latter case, the loss is taken into account in computing the company's profits, in the former case, it is not. That suffices to trigger Article 43 EC. [4] The issue before this Court is whether the contested measure may none the less be justified, and in particular (i) whether the grounds of justification accepted by the Court in *Marks & Spencer* [5] in the context of the deduction of losses made by *subsidiaries* are applicable

3 — The French Government has a variation on this theme, simply saying that the analysis and justification are in any event the same in both cases.

4 — If authority should be required, it may be found in Case C-141/99 *AMID* [2000] ECR I-11619, paragraphs 21 to 23, and Case C-298/05 *Columbus Container Services* [2007] ECR I-10451, paragraph 53.

5 — Case C-446/03 [2005] ECR I-10837.

in the context of the deduction of losses made by a *permanent establishment* and (ii), if so, whether the contested measure is proportionate.

8. In *Marks & Spencer* the Court recognised that national legislation which prevented a resident company from deducting from its taxable profits losses incurred by a subsidiary established in another Member State while permitting it to deduct losses incurred by a resident subsidiary amounted to a restriction on the freedom of establishment contrary to Articles 43 and 48 EC. However, the Court went on to hold that the restriction was justified on the grounds of (i) the aim of preserving the allocation of the power to impose taxes, (ii) the danger that losses might be used twice and (iii) the risk of tax avoidance, provided of course that it did not go beyond what was necessary to attain those objectives.

9. Lidl, Germany and the Commission submit [6] that those grounds of justification do not apply to legislation restricting the deduction of losses made by a permanent establishment. Finland, France, Greece, the Netherlands (in the alternative) and the United Kingdom submit, essentially, that the situation of permanent establishments is analogous to that of foreign subsidiaries; there is accordingly no need to distinguish *Marks & Spencer*.

10. In that case the Court prefaced its discussion of the three justifications by stating that, in order to ascertain whether restricting group relief to losses incurred by resident companies was justified, it was 'necessary to consider what the consequences would be if an advantage such as [group relief] were to be extended unconditionally'. [7] It was in that context that the Court considered, and accepted (subject to two provisos reflecting the need for proportionality), the three justifications put forward by the United Kingdom and the other Member States which had submitted observations. I see no reason for not adopting the same approach when assessing whether a measure limiting relief for losses incurred by a permanent establishment of a resident company to those losses incurred by its resident permanent establishments is compatible with the Treaty. From the point of view of the company, the ability to deduct losses of a foreign subsidiary by way of group relief is clearly analogous to the ability to deduct losses of a foreign permanent establishment. Indeed, the purpose of group relief is to avoid penalising companies

6 — At least in the context of certain arguments.

7 — Paragraphs 40 and 41.

which, rather than establishing branches, decide to expand their activities by setting up subsidiaries. [8]

11. Whether any or all [9] of the three justifications may apply in a given situation involving a permanent establishment rather than a subsidiary is a different issue.

12. With regard to the first justification, it seems to me that the preservation of the allocation of the power to impose taxes between Member States might mean that the economic activities of the permanent establishment in one Member State of a company established in another should be subject only to the tax rules of the first State in respect of both profits and losses. [10] The Member State concerned in *Marks & Spencer* (the United Kingdom) did not assert taxing rights over foreign subsidiaries of resident companies. In the present case, the Member State concerned would, in the absence of the DTC, have the right to tax a cross-border permanent establishment but has waived that right by exempting profits of such an establishment from tax. The effect is the same. As the Court stated in *Marks & Spencer*, 'to give companies the option to have their losses taken into account in the Member State in which they are established or in another Member State would significantly jeopardise a balanced allocation of the power to impose taxes between Member States, as the taxable basis would be increased in the first State and reduced in the second to the extent of the losses transferred'. [11] Similarly in the present case it would entail a breach of the symmetry between taxation and reliefs agreed by Germany and Luxembourg and reflected in the DTC if Germany were to grant relief for losses incurred by a Luxembourg permanent establishment of a German company where it had waived the right to tax profits made by such an establishment.

13. With regard to the second justification, the Court in *Marks & Spencer* stated that Member States must be able to prevent the danger that losses might be used twice, that that danger exists if group relief is extended to the losses of non-resident subsidiaries and that it is avoided by a rule which precludes relief in respect of those losses. [12]

14. Again, I do not see why that principle should not apply in a case such as the

8 — See point 16 of the Opinion of Advocate General Poiares Maduro in *Marks & Spencer*.

9 — The question whether the three justifications must be considered cumulatively is considered below.

10 — *Marks & Spencer*, paragraph 45.

11 — Paragraph 46.

12 — Paragraph 47 and 48.

present. There is clearly scope for the same loss to be used twice. If anything that risk is greater in the context of losses made by a permanent establishment which remains in business than in the context (as in *Marks & Spencer*) of losses made by subsidiaries which had been sold to third parties or ceased trading. In the former context, if the losses could be used in the Member State where the company was resident there is a risk that they would be claimed again in the Member State of the permanent establishment once the permanent establishment became profitable, without the Member State where the company was resident being able to recoup the benefit obtained. Indeed it appears from the reply from the representative of Lidl to a question put by the Judge Rapporteur at the hearing in the present case that the loss which prompted the reference has now been set off against profits made in Luxembourg. [13] As the Court stated in *Marks & Spencer*, Member States must be able to tackle the risk that losses will be used twice, and that risk is avoided by a rule which precludes relief in respect of those losses. [14]

15. With regard to the third justification, relating to the risk of tax avoidance, the Court stated in *Marks & Spencer* that the possibility of transferring the losses incurred by a non-resident company to a resident company entails the risk that within a group of companies losses will be transferred to companies established in the Member States which apply the highest rates of taxation and in which the tax value of the losses is therefore the highest. In contrast to the situation concerning subsidiaries, where it is conceivable that the transfer of losses will be systematically organised within groups of companies and losses directed solely to companies of the group established in Member States with higher rates of taxation, [15] in the case of permanent establishments there is clearly no scope for such 'jurisdiction shopping' if a company in one Member State is allowed to deduct losses made by a permanent establishment in another Member State. That is because, as the Commission submits, measures enabling the 'transfer' of losses from a permanent establishment, as opposed to a subsidiary, are neither necessary nor theoretically conceivable: losses made by a permanent establishment are losses of the taxpayer 'parent' company. Losses made by national permanent establishments can accordingly be directly and immediately deducted. The only difference between that domestic situation and the present case lies in the allocation of the power to impose taxes: if the permanent establishment is resident in another Member State with which there is a double taxation convention such as that at issue in the present case, that State will have the exclusive right to tax the income of the permanent establishment in question. That does not affect the fact that a loss accrues to the taxpayer company, directly reducing its taxable income in its State of residence. The other State's right to tax simply creates a second connecting factor for the same

13 — Since the loss was made in 1999 but could not be used in Luxembourg until 2003, Lidl was still disadvantaged by its inability to set the loss off against its profits in Germany at an earlier stage. The issue of cash flow is explored further below, in the context of proportionality.

14 — Paragraphs 47 and 48.

15 — Although it may be noted that tax avoidance by such 'trafficking in losses' does not appear to have been relevant on the facts in *Marks & Spencer*, which solely concerned vertical upwards transfer of losses from subsidiary to parent.

loss and, therefore, the potential for double deduction. In cases such as the present, therefore, it seems to me that the third *Marks & Spencer* justification adds nothing to the first and second grounds.

16. I accordingly agree with, variously, Finland, France, Germany, Greece, the Netherlands, Sweden, the United Kingdom and the Commission that national legislation restricting the possibility for a company to deduct losses made by a permanent establishment in another Member State may be justified by, first, the need to preserve the balanced allocation of the power to impose taxes between the different Member States concerned and, second, the risk that losses might be taken into account twice.

17. The Bundesfinanzhof notes in the order for reference that it is uncertain whether the Court intended the three justifications in *Marks & Spencer* to be cumulative, so that all three must be present.

18. Admittedly the Court in *Marks & Spencer* referred to the 'three justifications, taken together', which supports that view. In *N*, however, the Court stated that 'preserving the allocation of the power to tax between Member States is a legitimate objective' without reference to other grounds. [16] In *AA*, the Court accepted that legislation of a Member State which precludes a subsidiary resident in that Member State from deducting a financial transfer to its parent company from its taxable income unless that parent company is established in the same Member State could in principle be justified on the basis of two of the three *Marks & Spencer* grounds, namely the first and the third. [17] And in *Amurta* the Court, having stated that the second and third *Marks & Spencer* justifications had not been pleaded, none the less went on to consider (and reject) an argument based on the need to safeguard the balanced allocation between the Member States of the power to tax. [18] It seems, therefore, that the three justifications do not necessarily all have to be applicable in a given case. In my view the legislation at issue in the present case could in principle be justified

16 — Case C-470/04 [2006] I-7409, paragraph 42.
17 — Case C-231/05 [2007] ECR I-6373, paragraphs 51 to 60.
18 — Case C-379/05 [2007] ECR I-9569, paragraphs 57 to 59.

by reference to the first and second *Marks & Spencer* grounds, namely the objectives of preserving the balanced allocation of the power to impose taxes and of avoiding the danger that losses would be used twice.

19. In order for a restrictive measure to be justified it must in addition comply with the principle of proportionality, in that it must be appropriate for securing the attainment of the objectives it pursues and must not go beyond what is necessary to attain those objectives.

20. In the present case, there is nothing to suggest that the contested measure is not appropriate for securing the attainment of the abovementioned objectives. In contrast, I cannot accept that it does not go beyond what is necessary to attain them, or, in other words, that it would not have been possible to achieve the same result by less stringent measures.

21. The Court has stated that compliance with the principle of proportionality is especially important where national legislation excludes cross-border transactions from national rules altogether. [19] In such a situation, where the national legislation at issue is by definition severely restrictive, it is all the more important to consider carefully whether its aim could not be attained by less restrictive measures.

22. In the present case, the contested measure precludes a company from offsetting against its profits losses made by a permanent establishment in another Member State. The effect is that, in certain circumstances, a company will be taxed on more than its total net profits. That, to me, is a manifestly disproportionate means to the ends of preserving the balanced allocation of the power to impose taxes and of avoiding the danger that losses may be used twice.

23. It is, moreover, clear that less restrictive measures are possible. It is common ground that, prior to 1999, German legislation [20] expressly provided that a company could deduct a loss made by a permanent establishment in another Member State to the extent to which it exceeded profits made by the permanent establishment and subject to the

19 — Case C-334/02 *Commission* v *France* [2004] ECR I-2229, paragraph 28.

20 — Paragraph 2a(3) of the Einkommensteuergesetz (Income tax law) 1997 (BGBl. 1997 I, p. 821).

deduction being brought back into account in subsequent years in which the permanent establishment made a profit.

24. Such a rule, which allowed the deduction of losses while providing for the recapture of the loss relief in future profitable periods, would manifestly be a less restrictive means of avoiding the risk that losses might be used twice than a rule altogether excluding relief for such losses. Although a deduction-and-recapture rule involves a loss of symmetry and hence does not wholly attain the objective of the balanced allocation of the power to tax, that asymmetry is merely temporary where the permanent establishment subsequently becomes profitable. Moreover provision could be made for automatic reincorporation of amounts previously deducted if reincorporation had still not occurred after, for example, five years, or if the permanent establishment ceased to exist in that form. [21]

25. Such a deduction-and-recapture rule is unarguably less restrictive of the taxpayer's fundamental right of establishment than an outright prohibition of deducting from the profits of a company losses made by a permanent establishment in another Member State. At the same time it is still appropriate for attaining the objectives of preserving the balanced allocation of the power to impose taxes and of avoiding the danger that losses would be used twice. To my mind, it thus manifestly better reflects the need for proportionality than the solution adopted by the Court in *Marks & Spencer*.

26. The Court stated in *Marks & Spencer* itself that the restrictive measure (group loss relief legislation not extending to foreign subsidiaries) went beyond what was necessary to attain the essential part of the objectives pursued where the possibilities for having the losses taken into account in the subsidiary's State of residence had been exhausted. [22] It may therefore be assumed (although the judgment is extremely laconic on this issue) that the Court considered that in other circumstances the restrictive measure would have been proportionate.

27. It must, however, be borne in mind that *Marks & Spencer* concerned losses made by subsidiaries which had been wound up or sold. There was accordingly no possibility

21 — As suggested in the Commission's Proposal for a Council directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States, COM(90) 595 final; 24 January 1991 (OJ 1991 C 53, p. 30): see Articles 5 to 8 and the Explanatory Memorandum.

22 — Paragraph 55. The Court lays down a double test: exhaustion of the possibility of loss relief for the current and previous accounting periods, and 'no possibility for the foreign subsidiary's losses to be taken into account in its State of residence for future periods'.

(at least in the former case) of recapturing in the future any loss relief given. [23] In those circumstances it is perhaps understandable that the Court framed its answer as it did and failed to complete its analysis by examining in detail whether the cash-flow disadvantage of having to carry losses forward instead of using them immediately was not an overly restrictive way of attaining the objectives sought.

28. In cases such as the present, in contrast, which concern an ongoing permanent establishment, it cannot be argued that the possibility of carrying forward losses in the State of the permanent establishment is an acceptable substitute for granting relief in the State of residence of the company. Even where a loss which is carried forward is subsequently offset, the company will in the mean time by definition have suffered a cash-flow disadvantage.

29. The Court is well aware of the significance of cash flow to undertakings. It has repeatedly held that the exclusion of a cash-flow advantage in a cross-border situation where it is available in an equivalent domestic situation is a restriction on the freedom of establishment. [24] Indeed it made this very point forcefully in *Marks & Spencer*. There, it explained in terms that, by speeding up the relief of the losses of the loss-making companies by allowing them to be set off immediately against the profits of other group companies, the group loss relief at issue conferred a cash advantage on the group. The exclusion of such an advantage in respect of the losses incurred by a subsidiary established in another Member State was such as to hinder the exercise by that parent company of its freedom of establishment by deterring it from setting up subsidiaries in other Member States. Thus, it constituted a restriction on freedom of establishment. [25]

30. That statement was made in the (analytically prior) context of whether the inability to deduct cross-border losses was a restriction contrary to Article 43. It seems anomalous that, having clearly accepted the potential significance of the denial of a cash-flow advantage and categorised it (correctly) as a prima facie infringement of Article 43 EC, the Court did not also examine expressly whether, where the restriction was prima

23 — Advocate General Kokott took the view in her Opinion in *AA*, cited in footnote 17, that, essentially, the Court's ruling on proportionality in *Marks & Spencer* derived from its exceptional facts (points 70 and 71). I agree.

24 — See for example Joined Cases C-397/98 and C-410/98 *Metallgesellschaft* [2001] ECR I-1727, paragraphs 44, 54 and 76; Case C-436/00 *X and Y* [2002] ECR I-10829, paragraphs 36 to 38; Case C-268/03 *De Baeck* [2004] ECR I-5961, paragraph 24; Case C-446/04 *Test Claimants in the FII Group Litigation* [2006] ECR I-11753, paragraphs 96, 97, 153 and 154; and Case C-347/04 *Rewe Zentralfinanz* [2007] ECR I-2647, paragraph 29.

25 — Paragraphs 32 to 34.

facie justified, the denial of a cash-flow advantage which was an unavoidable consequence was disproportionate.

31. Germany, Sweden and the United Kingdom argue that significant practical difficulties preclude adopting a system allowing for deduction of losses combined with recapture of loss relief. However, as indicated above it appears that German legislation previously provided for such a system; indeed Lidl and the Commission have stated without being contradicted that legislation to essentially the same effect was in force in Germany from 1969 [26] until its repeal in 1999. [27] Moreover, according to a recent Communication from the Commission [28] five Member States currently provide for deduction of losses sustained by permanent establishments situated in another Member State, even though profits are exempted under a double taxation convention. Against that background it is difficult to take seriously the argument that significant practical difficulties preclude such a system. [29] In any event, practical difficulties cannot justify infringement of a Treaty freedom. [30]

32. I accordingly agree with Lidl, the Finnish Government and the Commission that the national legislation goes beyond what is necessary to attain the objectives of preserving the balanced allocation of the power to impose taxes and of avoiding the danger that losses would be used twice.

33. Finally, Germany submits in the (further) alternative that, if the Court were to rule that the freedom of establishment has been infringed, it should limit the effects of the judgment in time.

34. It is clear from the Court's case-law that the financial consequences which might ensue for a Member State from a preliminary ruling do not in themselves justify limiting the temporal effects of the ruling and that such a limitation will be imposed only in very specific circumstances, namely where (a) there is a risk of serious economic

26 — Paragraph 2 of the Gesetz über steuerliche Massnahmen bei Auslandinvestitionen der deutschen Wirtschaft (Law on fiscal measures applicable to foreign investments of German industry) of 18 August 1969 (BGBl. 1969 I, pp. 1211, 1214).

27 — By the Steuerentlastungsgesetz (Law on tax relief) 1999/2000/2002 of 24 March 1999 (BGBl. 1999 I, p. 402).

28 — Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee on Tax Treatment of Losses in Cross-Border Situations (COM(2006) 824 final, 19 December 2006); see point 2.2(b)(2).

29 — It may be noted that Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation and taxation of insurance premiums (OJ 1977 L 336, p. 15) allows a Member State to request from the competent authorities of another Member State all the information enabling it to ascertain the correct amount of corporate tax.

30 — *Commission* v *France*, cited in footnote 19, paragraph 29, referring to point 30 of the Opinion of Advocate General Ruiz-Jarabo Colomer: 'Once it has been established that the objective pursued can be fulfilled by other means, the principle of proportionality precludes mere administrative difficulties from being cited as absolute grounds justifying discriminatory treatment which, because it is contrary to the fundamental freedoms, must be based on strong reasons in order to be lawful'. See also *Test Claimants in the FII Group Litigation*, cited in footnote 24, paragraphs 155 to 157.

repercussions owing in particular to the large number of legal relationships entered into in good faith on the basis of rules considered to be validly in force and (b) it appears that both individuals and national authorities have been led into adopting practices which did not comply with Community law by reason of objective, significant uncertainty regarding the implications of Community provisions, to which the conduct of other Member States or the Commission may even have contributed. [31]

35. In the present case I agree with Lidl that the second of those cumulative conditions is not satisfied. I cannot accept that, when Germany repealed the earlier legislation and thus in effect reinstated the contested measure, it can plausibly be described as having been led into taking that step by reason of objective, significant uncertainty regarding the implications of Article 43 EC. By 1999 the Court had already ruled that national legislation which essentially denied group loss relief where a majority of the subsidiaries were resident in other Member States was contrary to Article 43 EC [32] and that the freedom of companies exercising their right of establishment to choose whether to do so by a subsidiary or branch (permanent establishment) must not be limited by discriminatory tax provisions. [33] Morever the Proposal for a Council directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States, [34] issued in 1991, makes the Commission's view clear: national legislation which does not permit enterprises to take into account the losses incurred by their permanent establishments situated in other Member States is incompatible with the internal market. [35]

36. Accordingly I am not persuaded that there is in the present case any justification for limiting the temporal effects of the ruling.

31 — See most recently Case C-313/05 *Brzeziński* [2007] ECR I-513, paragraphs 57 and 58.

32 — Case C-264/96 *ICI* [1998] ECR I-4695.

33 — Case 270/83 *Commission* v *France* [1986] ECR 273, paragraph 22.

34 — Cited in footnote 21.

35 — See the first recital in the preamble and point 1 of the Explanatory Memorandum.

Conclusion

37. In the light of the above I am of the view that the Court should answer the question referred by the Bundesfinanzhof as follows:

'It is not compatible with Article 43 EC for a Member State to preclude a company, when calculating its taxable profits, from deducting losses from a permanent establishment in another Member State on the ground that, according to the applicable double taxation convention, the corresponding income from such a permanent establishment is not subject to taxation in the first Member State.'