DIRECT TAXATION. CASE LAW

4 Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt. Cross-border loss relief. ECJ (comments by Englisch, Kofler and Paternotte)

According to former German tax law, losses of a foreign permanent establishment (PE) could be taken in account in Germany even if the exemption method applied to profits attributable to that PE. However, as a general rule, any such deduction would give rise to the taxation of subsequent profits resulting from the activities of the PE in question, up to the amount of previously deducted losses. Krankenheim Wannsee was a company established in Germany which operated a PE situated in Austria from 1982 to 1994. Before the end of 1990, the Austrian PE incurred losses, which were set off against company profits made in Germany. Between 1991 and 1994, the PE became profitable again. In 1994, the branch was wound up. The profits earned in 1994, the year at issue, were added to the German corporation tax base, since not all previous PE losses had yet been recouped. The German Federal Tax Court questioned the compatibility of such treatment with the freedom of establishment and referred the case to the ECJ. The ECJ held that the system of 'reintegration of PE losses' upon subsequent profits infringed Art. 31 EEA. It also, however, ruled that this infringement could be justified on grounds of fiscal cohesion. The ECJ furthermore decided that a possible restriction resulting from an eventual double non-consideration of losses would in all events only be imputable to Austria.

European Court of Justice, 23 October 2008, no. C-157/07
(Lenaerts, Juhász, Arestis, Malenovský, Silva de Lapuerta)

Judgment

1. The reference for a preliminary ruling concerns the interpretation of Article 31 of the European Economic Area Agreement of 2 May 1992 (JO 1994, L 1, p. 3, 'the EEA Agreement').

2. It has been submitted in a dispute between the Finanzamt für Körperschaften III in Berlin ('the Finanzamt') and Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH ('KR Wannsee') concerning the tax treatment in Germany of losses incurred by a permanent establishment situated in Austria and belonging to KR Wannsee.

Legal context

International law

3. Article 6 of the EEA Agreement provides:

'Without prejudice to future developments of case-law, the provisions of this Agreement, in so far as they are identical in substance to corresponding rules of the Treaty establishing the European Economic Community and the Treaty establishing the European Coal and Steel Community and to acts adopted in application of these two Treaties, shall, in their implementation and application, be interpreted in conformity with the relevant rulings of the Court of Justice of the European Communities given prior to the date of signature of this Agreement.'

4. Article 31 of the EEA Agreement reads:

'Within the framework of the provisions of this Agreement, there shall be no restrictions on the freedom of establishment of nationals of an EC Member State or an EFTA [European Free Trade Association] State in the territory of any other of these States. This shall also apply to the setting-up of agencies, branches or subsidiaries by nationals of any EC Member State or EFTA State established in the territory of any of these States.

Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms within the meaning of Article 34, second paragraph, under the conditions laid down for its own nationals by the law of the country where such establishment is effected, subject to the provisions of Chapter 4.'

...'

5. The second paragraph of Article 34 of the EEA Agreement provides:

'"Companies or firms" means companies or firms constituted under civil or commercial law, including cooperative societies, and other legal persons governed by public or private law, save for those which are non-profit-making.'

6. The Agreement concerning the avoidance of double taxation with respect to taxes on income and capital and to trade and property taxes concluded between the Federal Republic of Germany and the Republic of Austria on 4 October 1954 (BGBl. 1955 II, p. 749), as amended by the Agreement of 8 July 1992 (BGBl. 1994 II, p. 122; 'the German-Austrian Agreement'), provides in Article 4:

'1 Where a person domiciled in one of the Contracting States derives income, as owner or partner, from a business enterprise whose activities extend to the territory of the other State, the said income shall be taxable by the latter State only in so far as it is attributable to a permanent establishment of the enterprise which is situated in its territory.

2. In this connection, the income to be attributed to a permanent establishment shall be that which would have accrued to it if it had been an independent enterprise engaged in the same or similar activities under the same or similar conditions and had carried on its activities as an independent enterprise.

3. For the purposes of this Agreement, the term "permanent establishment" means a fixed place of business in which an enterprise carries on all or part of its activities.

...'

7. Article 15 of the German-Austrian Agreement provides:

'1 The State of domicile shall have no right to tax if, in the foregoing articles, such right has been assigned to the other State

...

3. Paragraph (1) shall not preclude the State of domicile from raising taxes on the income and properties left thereto for taxing at the rate corresponding to the total income and total property of the taxable person.'

8. Article 12(b) of the protocol of 24 August 2000 to the Agreement concerning the avoidance of double taxation with respect to taxes on income and capital and to trade and property taxes, concluded between the Federal Republic of Germany and the Republic of Austria on 4 October 1954 (BGBl. 2002 II, p. 734), stipulates that losses incurred as from the business year 1998 are to be taken into account on the basis of reciprocity in the State where the permanent establishment concerned is situated. That provision is worded as follows:

'Where persons resident in Germany incur, from the business year 1990 (1989/90) onwards, losses in establishments situated in Austria, losses incurred up to the 1997 (1996/97) business year inclusive shall be taken into account in accordance with Article 2a(3) of the German Law on Income Tax (Einkommenssteuergesetz, BGBl. 1988 I, p. 1093; "the EStG"). As from the tax year 1994, the taking into account of sums initially deducted, in accordance with the third sentence of Article 2a(3) of the EStG shall not apply. Where tax treatment cannot be carried out in accordance with those provisions in Germany, given the definitive nature of the taxation and the impossibility of restarting the procedure by reason of the expiry of the period laid down for determination of the tax, account may be taken in Austria in the form of a deduction of losses. Losses incurred as from the business year 1998 (1997/98) must be taken into account in the State where the establishment is situated in accordance with the principle of reciprocity. The above rules apply only in so far as they do not cause losses to be taken into account twice.'

German law

9. Article 2(1) of the Law on tax measures applicable to the investments of German undertakings abroad (Gesetz über steuerliche Maßnahmen bei Auslandsinvestitionen der deutschen Wirtschaft (Auslandsinvestitionsgesetz) of 18 August 1969 (BGBl. 1969 I, p. 1211; 'the AIG'), which was in force at the time of the facts in the main proceedings, was worded as follows:

'Where, under a double taxation agreement, a fully-taxable person is to be exonerated from income tax in relation to the results of an industrial or commercial undertaking established in a foreign State, it is appropriate, at the request of the taxable person, to deduct, in the calculation of the total amount of income, a loss arising from those results in accordance with the provisions of national tax law, where that loss could be offset or deducted by the taxpayer, if that income did not have to be exonerated, and where it exceeds the positive income of an industrial or commercial activity, arising from other operations in the same foreign State, exonerated by virtue of that agreement. Where that does not involve the offsetting of the loss, deduction of the latter is allowed where the conditions laid down in Article 10d of the EStG are met. The deducted amount, in accordance with the first and second sentences, must again be taken into account in the calculation of the total amount of income, for the taxation period concerned, where, in one of the following taxation periods, an overall profit arises from the results of an industrial and commercial activity from operations established in that foreign State, that positive income being exonerated in accordance with the agreement in question. The third sentence does not apply where the taxpayer shows that, by virtue of the provisions laid down by the foreign State which are applicable to him, he is not authorised to deduct those losses from results other than those of the year during which the loss was incurred.'

10. From 1990 onwards, the rules on the right to deduct were set out in Article 2a(3) of the EStG.

Austrian law

11. Until 1988, Austrian tax law made no provision for the carrying forward of losses incurred by partially-taxable companies, i.e. by permanent establishments belonging to companies based in the territory of a State other than the Republic of Austria. It was only in 1989 that the deduction of losses incurred by those permanent establishments was introduced in Austria, including in relation to losses incurred before 31 December 1988, during the preceding seven years.

12. Such carrying forward was however allowed in relation to losses incurred by permanent establishments situated in the territory of the Republic of Austria and belonging to companies established in another State, i.e. by partially-taxable taxpayers, only if the undertaking concerned did not make any profit overall, i.e. as regards its worldwide income. Losses incurred by a permanent establishment situated in Austria could therefore be taken into account only in so far as they were greater than the profits made outside the scope of the partial taxation. Moreover, such a deduction was possible only in so far as the losses were determined on the basis of regular accounting and had not already been taken into account in taxation during previous tax years.

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

13. KR Wannsee, the respondent in an appeal on a point of law ('Revision'), is a limited liability company established in Germany which operated a permanent establishment situated in Austria from 1982 to 1994. Before the end of 1990, it made losses for that establishment totalling DEM 2.467.407, of which DEM 36.295 related to that year.

14. At the request of KR Wannsee, those losses were taken into account by the Finanzamt, the appellant in the said appeal, in calculating the taxable amount for that company, that is to say having regard to the profits made in Germany, by the latter, during the taxation periods corresponding to the years 1982 to 1990.

15. Between 1991 and 1994, at its permanent establishment in Austria, KR Wannsee made profits of DEM 1.191.672, of which DEM 746.828 were made during the year 1994 which is at issue in the main proceedings. That same year, KR Wannsee disposed of that permanent establishment.

16. In accordance with the provisions of German tax law then in force, the Finanzamt added the profits made by the permanent establishment in Austria during the period 1991 to 1994 to the total income obtained by KR Wannsee in Germany. The Finanzamt thus retrospectively taxed the sums previously deducted in the context of national taxation, in respect of the losses incurred by the permanent establishment in Austria. In respect of the period of taxation at issue in the main proceedings, namely the year 1994, the taxable income of KR Wannsee was thus increased by the profits made by that permanent establishment during that year, amounting to DEM 746.828.

17. In Austria, KR Wannsee was charged corporation tax in 1992 and 1993, during which business years its permanent establishment made profits. On that occasion, the losses previously incurred by that company in the said establishment were not taken into account. Having regard to the fact that the Republic of Austria permitted deduction of losses only in the alternative, in cases where it was not possible to take them into account in the State where the company owning the permanent establishment was established, and given that KR Wannsee had made profits in Germa-

ny between 1982 and 1990, it was refused offsetting of losses in Austria in respect of the years 1992 and 1993.

18. As regards 1994, the permanent establishment of KR Wannsee should, in accordance with Austrian tax provisions, have been taxed on profits made during that year. However, no assessment to corporation tax was made in Austria for that year, contrary to what had been the case for 1992 and 1993.

19. Following the Finanzamt's decision to calculate the whole of the income derived by KR Wannsee in Germany taking account of profits made by its permanent establishment in Austria, that company brought an action against the tax notices for the years 1992 to 1994, requesting deduction of the sums which had been reintegrated into the basis for calculation of the tax drawn up in Germany. KR Wannsee argued in support of its action that, by reason of the carrying forward of losses in Austria being limited to seven years, reintegration of those sums on the basis of the provisions of the AIG was unlawful.

20. The Finanzgericht Berlin dismissed KR Wannsee's action against the tax notices for 1992 and 1993, but upheld its action against the tax notice for 1994.

21. The Bundesfinanzhof, to which the Finanzgericht referred the dispute at final instance on the subject of the reintegration made in respect of the tax year 1994, expressed doubts as to whether the national legislation complied with Community law.

22. In those circumstances, the Bundesfinanzhof decided to stay the proceedings and refer the following questions to the Court of Justice for a preliminary ruling:

'1 Does Article 31 of the [EEA] Agreement prohibit a legal provision of a Member State according to which, when calculating total income, a taxpayer resident and subject to unlimited taxation in one Member State is able under certain conditions to deduct losses incurred by a permanent establishment situated in another Member State which are exempt from income tax pursuant to a double taxation convention,

– but according to which the sum deducted must, in the tax assessment period concerned, be added back in the calculation of total income, to the extent to which, in a subsequent tax assessment period, a positive amount of income from commercial activities which is exempt from tax pursuant to the double taxation convention is generated by permanent establishments in that other Member State,

– subject in the latter case to an exception where 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 deduction of losses in a year other than that in which those losses were incurred, which is not the case where, although a deduction of losses is in general possible according to the law of that State, it is not available to the taxpayer in the specific situation in which he finds himself?

2. If the answer to (1) is in the affirmative: is the position in the State of residence affected if the limitations on deduction of losses applicable in the other Member State (being the source State) themselves contravene Article 31 of the [EEA] Agreement on the ground that they discriminate against a taxpayer with income from his permanent establishment who is subject only to limited taxation there compared with a taxpayer who is subject to unlimited taxation there?

3. Further assuming that the answer to (1) is in the affirmative: must the State of residence 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 Member State on the ground that the permanent establishment in that other Member State has been disposed of?'

The questions referred for a preliminary ruling

The applicability of Article 31 of the EEA Agreement

23. By way of preliminary observation, it should be noted that the provisions of the EEA Agreement on the freedom of establishment applied to the relations between the Federal Republic of Germany and the Republic of Austria during the period from 1 January to 31 December 1994, since the latter State acceded to the European Union on 1 January 1995.

24. Concerning the scope of those provisions, the Court has held that the rules prohibiting restrictions on the freedom of establishment, set out in Article 31 of the EEA Agreement, are identical to those imposed by Article 43 EC (Case C-471/04*Keller Holding* [2006] ECR I-2107,

paragraph 49). The Court has also held that, in the area in question, the rules of the EEA Agreement and those of the EC Treaty must be given a uniform interpretation (Case C-452/01*Ospelt and Schlössle Weissenberg* [2003] ECR I-9743, paragraph 29; Case C-286/02 *Bellio F.lli* [2004] ECR I-3465, paragraph 34).

25. As for the applicability of Article 31 of the EEA Agreement to the facts of the main proceedings, the German Government argues that, given that, during all the years concerned by the deduction of losses, namely the years 1982 to 1990, the EEA Agreement was not yet in force, the tax mechanism at issue in the main proceedings cannot be assessed in relation to the said article, since the relevant time for determining the applicable legislation is that of the initial deduction of the losses.

26. In that respect, it should be noted that, despite the fact to which attention has thus been drawn, it is not deduction of losses but reintegration into the basis of assessment which is the element to be assessed by the Court, and that that reintegration took place in 1994. Since the EEA Agreement entered into force on 1 January 1994, the tax mechanism at issue in the main proceedings may be examined in relation to Article 31 of that Agreement.

The existence of a restriction on the right set out in Article 31 of the EEA Agreement

27. By its questions, which should be examined together, the referring court asks, in substance, whether Article 31 of the EEA Agreement precludes a national tax system which, having allowed losses incurred by a permanent establishment situated in a State other than the one in which the company to which that establishment belongs is established to be taken into account for the purposes of calculating the tax on that company's income, provides for tax reintegration of those losses at the time when the said permanent establishment makes profits, where the State where that permanent establishment is situated does not confer any right to carry forward losses incurred by a permanent establishment belonging to a company established in another State, and where, by virtue of an agreement between the two States concerned for the prevention of double taxation, the income of such an entity is exonerated from taxation in the State in which the company to which it belongs has its seat.

28. Freedom of establishment includes, for companies or firms formed in accordance with the laws of a Member State and having their registered office, central administration or principal place of business within the Community, the right to pursue their activities in the Member State concerned through a subsidiary, a branch or an agency (Case C-307/97*Saint-Gobain ZN* [1999] ECR I-6161, paragraph 35; Case C-141/99*AMID* [2000] ECR I-11619, paragraph 20; *KellerHolding*, paragraph 29).

29. The Court has also held that, even though, according to their wording, the provisions of the Treaty concerning freedom of establishment are directed to ensuring that foreign nationals and companies are treated in the host Member State in the same way as nationals of that State, they also prohibit the Member State of origin from hindering the establishment in another Member State of one of its nationals or of a company incorporated under its legislation (Case C-264/96*ICI* [1998] ECR I-4695, paragraph 21; Case C-298/05*Columbus Container Services* [2007] ECR I-10451, paragraph 33).

30. Moreover, it is settled case-law that all measures which prohibit, impede or render less attractive the exercise of that freedom must be regarded as such restrictions (Case C-55/94*Gebhard* [1995] ECR I-4165, paragraph 37; Case C-442/02*CaixaBank France* [2004] ECR I-8961, paragraph 11).

31. Those considerations also apply where a company established in a Member State carries on business in another Member State through a permanent establishment (Case C-414/06*Lidl Belgium* [2008] ECR I-0000, paragraph 20).

32. Concerning the effects of the German tax system in relation to Community law, it is clear from paragraph 23 of the judgment in *Lidl Belgium* that provisions which allow losses incurred by a permanent establishment to be taken into account in calculating the profits and taxable income of the principal company constitute a tax advantage. Granting or not granting such an advantage for a permanent establishment situated in a Member State other than that in which that company is established must therefore be regarded as a factor likely to affect the freedom of establishment.

33. It is true that, unlike the legislation at issue in *Lidl Belgium*, the German tax system at issue in the main proceedings provides that, in the results of the company established in Germany to

which the permanent establishment in Austria belongs, losses made by that permanent establishment are to be taken into account.

34. As already pointed out in paragraph 14 of this judgment, all the losses incurred by the permanent establishment in Austria were, initially, deducted from the profits made by the principal company in the context of that company's taxation in Germany.

35. By its action, the Federal Republic of Germany granted a tax advantage to the resident company with the permanent establishment situated in Austria, in the same way as if that permanent establishment had been situated in Germany.

36. However, by subsequently proceeding to reintegrate losses by the said permanent establishment into the basis of assessment of the principal company when the latter had made profits, the German tax system withdrew the benefit of that tax advantage.

37. Even though that reintegration operated only up to the amount of the profits made by that permanent establishment, the fact remains that, to that extent, the German legislation thus subjected resident companies with permanent establishments in Austria to less favourable treatment than that enjoyed by resident companies with permanent establishments situated in Germany.

38. In those circumstances, the tax situation of a company which has its registered office in Germany and has a permanent establishment in Austria is less favourable than it would be if the latter were to be established in Germany. By reason of that difference in tax treatment, a German company could be discouraged from carrying on its business through a permanent establishment situated in Austria (*Lidl Belgium*, paragraph 25).

39. It must therefore be concluded that the tax system at issue in the main proceedings entails a restriction on the right set out in Article 31 of the EEA Agreement.

The existence of justification

40. It is clear from the Court's case-law that a restriction on the freedom of establishment is permissible only if it is justified by overriding reasons in the public interest. It is further necessary, in such a case, that its application be appropriate to ensuring the attainment of the objective in question and not go beyond what is necessary to attain it (*Lidl Belgium*, paragraph 27 and case-law cited).

41. In that respect, the referring court underlines the fact that the income derived by the permanent establishment in Austria is taxed not in Germany, that is to say in the Member State of residence of the principal company, but in Austria, in accordance with the provisions of the German-Austrian Agreement.

42. On that point, it should be noted that the reintegration of losses provided for by the German tax system at issue in the main proceedings cannot be dissociated from their having earlier been taken into account. That reintegration, in the case of a company with a permanent establishment in another State in relation to which that company's State of residence has no power of taxation, as the referring court indicates, reflects a logical symmetry. There was thus a direct, personal and material link between the two elements of the tax mechanism at issue in the main proceedings, the said reintegration being the logical complement of the deduction previously granted.

43. It must be concluded that the restriction which follows from the reintegration thus provided for is justified by the need to guarantee the coherence of the German tax system.

44. In that respect, it should be added that that restriction is appropriate to achieve such an objective, in that it operates in a perfectly symmetrical manner, only deducted losses being reintegrated.

45. Moreover, that restriction is entirely proportionate to the objective pursued, since the reintegrated losses are reintegrated only up to the amount of the profits made.

46. That assessment cannot be called into question by the combined effects, referred to by the referring court in its first and second questions, of the German tax system and the Austrian tax legislation at issue in the main proceedings.

47. The referring court states in that regard that the German tax legislation did not provide for a reintegration such as that at issue in the main proceedings where the taxpayer showed that the provisions applicable to him in a Member State other than that in which he was established did not in general allow him to benefit from a deduction of losses during years other than those in which they were incurred, which was not the case where that State provided, in principle, for such a possibility of deducting losses but that possibility could not be put into effect in the concrete

situation in which the taxpayer found himself. In the case in the main proceedings, KR Wannsee found itself unable to have the losses incurred between 1982 and 1990 taken into account by the Austrian tax authorities.

48. On that point, it should be remembered that, according to consistent case-law, in the absence of any unifying or harmonising Community measures, Member States retain the power to define the criteria for taxing income and wealth with a view to eliminating double taxation, by means of conventions if necessary (Case C-290/04*FKP Scorpio Konzertproduktionen* [2006] ECR I-9461, paragraph 54; Case C-374/04*Test Claimants in Class IV of the ACT Group Litigation* [2006] ECR I-11673, paragraph 52; Case C-231/05*Oy AA* [2007] ECR I-6373, paragraph 52).

49. That competence also implies that a Member State cannot be required to take account, for the purposes of applying its tax law, of the possible negative results arising from particularities of legislation of another Member State applicable to a permanent establishment situated in the territory of the said State which belongs to a company with a registered office in the first State (see, to that effect, *Columbus Container Services*, paragraph 51, and Case C-293/06*Deutsche Shell* [2008] ECR I-0000, paragraph 42).

50. The Court has held that freedom of establishment cannot be understood as meaning that a Member State is required to draw up its tax rules on the basis of those in another Member State in order to ensure, in all circumstances, taxation which removes any disparities arising from national tax rules, given that the decisions made by a company as to the establishment of commercial structures abroad may be to the company's advantage or not, according to circumstances (*Deutsche Shell*, paragraph 43).

51. Even supposing that the combined effect of taxation in the State where the principal company of the permanent establishment concerned is situated and tax due in the State where that establishment is situated might lead to a restriction of the freedom of establishment, such a restriction is imputable only to the latter of those States.

52. In such a case, that restriction would arise not from the tax system at issue in the main proceedings, but from the allocation of tax competences under the German-Austrian Agreement.

53. Nor can the assessment that the restriction arising from the said tax system is justified by the need to ensure the coherence of that system be called into question by the fact, referred to by the referring court in its third question, that the principal company disposed of its permanent establishment and that the profits and losses made by that establishment throughout its existence end with a negative result.

54. As has been stated in paragraph 42 of this judgment, the reintegration of the amount of the permanent establishment's losses in the results of the principal company is the indissociable and logical complement of their having previously been taken into account.

55. It follows from the whole of the above considerations that the answer to the questions referred must be that Article 31 of the European Economic Area Agreement does not preclude a national tax system which, after having allowed the taking into account of losses incurred by a permanent establishment situated in a State other than the one in which its principal company is situated, for the purposes of calculating the tax on that company's income, provides for a tax reintegration of those losses at the time when that permanent establishment makes profits, where the State where that same permanent establishment is situated does not confer any right to carry forward losses incurred by a permanent establishment belonging to a company established in another State, and where, under a convention for the prevention of double taxation between the two States concerned, the income of such an entity is exonerated from taxation in the State in which the principal company has its seat.

Costs

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

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

Article 31 of the Agreement on the European Economic Area of 2 May 1992 does not preclude a national tax system which, after having allowed the taking into account of losses incurred by a permanent establishment situated in a State other than the one in which its principal company is situated, for the purposes of calculating the tax on that company's income, provides for a tax reintegration of those losses at the time when that permanent establishment makes profits, where the State where that same permanent establishment is situated does not confer any right to carry forward losses incurred by a permanent establishment belonging to a company established in another State, and where, under a convention for the prevention of double taxation between the two States concerned, the income of such an entity is exonerated from taxation in the State in which the principal company has its seat.

Comment

European Context

The ECJ correctly assumed that the German system of 'reintegrating' losses incurred by an Austrian PE of a German company was covered by the freedom of establishment enshrined in Art. 31 EEA in the year 1994. Since both the ECJ and the EFTA Court have recognised the need to ensure that the rules of the EEA Agreement, which are identical in substance to those of the EC Treaty, are interpreted uniformly, the reasoning of the ECJ can be generalized with respect to similar loss recapturing rules that are potentially subject to review under the identical Art. 43 EC. By contrast, the initial tax treatment of the losses at issue before 1994 had not been scrutinized because Germany was then not bound by Art. 31 EEA or Art. 43 EC. Nevertheless, as pointed out in para. 35 of the judgment, no discriminatory restriction would have been found anyway.

The ECJ then went on to assess a 'less favourable treatment' of companies with a foreign PE in Austria as compared to companies with a domestic PE, because only losses of the former would be reintegrated into the tax base upon subsequent PE profits. In my view, this conclusion is flawed. The 'reintegration of losses' criticized by the ECJ is tantamount to a taxation of the subsequent PE profits, since the latter both trigger and limit such reintegration. Obviously, there is no difference in this regard between foreign and domestic branches. The ECJ has allowed itself to be confused by paying too much attention to the labelling of the procedure while ignoring its essence. Hence, it is not only superfluous but wrong to rely on fiscal cohesion to 'justify' the former German system: Firstly, such a reasoning furthers the deformation of the cohesion argument, which was originally – and convincingly –construed to require a direct link between tax advantage available *only* for cross-border activities on the one hand, and the offsetting of that advantage by a particular tax levy on the other (*cf.* ECJ 29 March 2007, C-347/04 *Rewe Zentralfinanz*, ECR I-2647, para. 61). However, in the case at hand, setting off a PE loss would also have been granted to a German company with a domestic branch, so there is no need for a specific compensation of that tax advantage in the case of foreign PEs. Secondly, within the inappropriate cohesion context, the proportionality analysis of the ECJ must necessarily lead to inconsistencies with its case law regarding international double taxation: The ECJ permits the 'reintegration' of losses only in so far as they have previously been deductible. As pointed out above, this is equivalent to a prohibition of taxing PE profits in so far as they exceed PE losses. Admittedly, this would indeed have constituted a treaty override possibly leading to double taxation. On other occasions, however, the ECJ had indicated that such effects do not violate EC fundamental freedoms (*cf.* ECJ 14 November 2006, C-513/04 *Kerckhaert-Morres* ECR I-10967, para. 24).

The statements of the ECJ regarding the combined effects of the German and the Austrian tax legislation are certainly more intriguing. In its previous *Marks & Spencer* judgment (ECJ 13 December 2005, C-446/03, ECR I-10837, para. 55), the ECJ held in general terms that under a domestic group loss relief scheme, a foreign subsidiary's losses must be taken into account if there was no further possibility for them to be set off in the subsidiary's State of residence in future periods. In *Lidl Belgium* (ECJ 15 May 2008, C-414/06, nyr, para. 44 et seq.), the ECJ clarified that the same applies *mutatis mutandis* to losses of foreign PEs if a Member State applies the exemption method symmetrically to PE profits and PE losses. No qualifications regarding the reasons for the lack of future loss carry-forward in the Member State of establishment were provided in those judgments. Therefore, most scholars believed that foreign losses had to be considered also if a foreign loss carry-forward had expired or was denied in the first place, and even if such treatment in itself was discriminatory and, therefore, violated

Art. 43 EC. Now the ECJ makes it quite clear that such 'negative results arising from particularities of legislation of another Member State' need not be compensated by a loss deduction in the Member State where the head office (or the parent company) is situated. The *Marks & Spencer*-style requirement of *ultima ratio* consideration of foreign losses has, therefore, effectively been reduced to constellations where losses can no longer be used because the PE (or the subsidiary) has been wound up. The permissibility of a 'reintegration' of losses even in the latter case (see para. 53 et seq.) is not self-contradictory if one recalls that in essence, this mechanism is not concerned with the need to take into account losses, which has already been complied with before, but rather with taxing profits.

Joachim Englisch

German context

The *Krankenheim Wannsee* judgment is not only sound in its final outcome, but also wise because it does not form a disincentive for the use of tax schemes which provide immediate relief for foreign losses under the condition of their later recoupment. As the ECJ held in its *Marks & Spencer* ruling (see above, at para. 56), Member States are not generally obliged to grant such favourable treatment, but many of them, nevertheless, have chosen to do so. Unfortunately, the German legislator abandoned this system in 1999, and at present shows no inclination to return to it. As a consequence, the prevailing opinion in Germany rules out the consideration of foreign PE losses if the corresponding PE profits are exempt under tax treaty rules. Furthermore, German courts and the German tax administration can now be expected to confine the exceptional consideration of such losses, which they have acknowledged in the wake of the *Lidl Belgium* decision, to constellations where their non-deductibility abroad is not caused by detrimental foreign tax regimes regarding loss carry-forward.

In general, the current tax policy trend in Germany is to restrict the taking into account of foreign losses as far as possible: In the course of the recent reform of the reorganization tax act, the previously granted transfer of a loss carry-forward in the event of a merger or division was abolished altogether in order to avoid a mandatory extension to losses of a foreign merged company. Moreover, a reform bill currently under debate in parliament provides for the abolition of the exemption with progression rule for income derived in EC or EEA Member States, which would mean that foreign losses would no longer even be taken into account for the determination of the income tax rate. It remains to be seen whether the ECJ will really accept this extreme infringement of the ability-to-pay principle to the detriment of cross-border investments and establishments on the grounds of a symmetrical treatment of profits and losses alone.

Joachim Englisch

Austrian context

Under Austrian domestic law, non-resident taxpayers may carry forward losses incurred in an Austrian permanent establishment only to the extent that these losses are greater than the profits made outside the scope of limited tax liability in Austria (§ 102(2)(2) EStG). This scheme, which has been applicable since 1990, has its main dogmatic underpinning in an avoidance of a double utilization of losses but, in principle, applies irrespective of whether or not the losses could be used in the head office's State or if such State applies a subsequent recapture mechanism.

This rule has been heavily criticized from the perspective of non-discrimination clauses in tax treaties, and in recent times, the Austrian Supreme Administrative Court (VwGH) as well as the tax administration grant a carry forward if a tax treaty permanent establishment non-discrimination clause applies and losses are not in fact utilized twice (see e.g., VwGH 16 February 2006, 2005/14/0036, ÖStZB 2006/402, 496, and VwGH 28 November 2007, 2007/14/0048, ÖStZB 2008/404, 502). Such double use of losses is deemed not to occur if, for example, the head office's State either does not take such losses into account, or if a double utilization is prevented in subsequent years either by a recapture mechanism under the exemption method (*VwGH* 28 November 2007, 2007/14/0048, *ÖStZB* 2008/404, 502) or by full inclusion of subsequent profits under the credit method (*VwGH* 16 February 2006, 2005/14/0036, *ÖStZB* 2006/402, 496). It is, however, heavily disputed if this is a correct interpretation of tax treaty non-discrimination clauses, as it would, in principle, be for the residence State and not for the source State to prevent unwanted double utilization of losses (see, e.g., *Rust* in *Vogel/Lehner*, DBA, 5th edition 2008, Art 24 Rz 100).

Furthermore, the prevailing opinion in the legal doctrine suggests that Austria's provision violates the EC freedom of establishment, a position that also the German Supreme Tax Court (BFH) had taken in its request for a preliminary ruling in *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt* (see *BFH* 29 November 2006, I R 45/05, BFHE 216, 149, BStBl 2007 II 398), and which the ECJ seems to have confirmed (see ECJ 23 October 2008, C-157/07 *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH*, para. 51). Although there is no explicit case law in Austria on the EC compatibility of the restriction on loss carry forwards, it is expected that the Austrian Supreme Administrative Court would also come to such conclusion, however, with the caveat that no double utilization of losses occurs. Again, the latter requirement seems to overstep the mark. Notably, the judgment in *Futura Participations* (Case C-250/95, [1997] ECR I-2471) seems to imply that a Member State may not take into account foreign profits in determining the amount of a domestic loss carry forward.

The problem of a potential double exclusion of loss utilization in *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt* hence occurred because the old tax treaty between Austria and Germany did not contain a non-discrimination clause for permanent establishments. However, the new treaty, which entered into force in 2003, does contain such a clause. The protocol to this treaty also establishes a bilateral agreement concerning losses of permanent establishments (Para. 12 lit. b of the Protocol to the Austrian-German treaty, Federal Gazette III 2002/182), which was implemented by unilateral ordinance for taxable periods prior the tax treaty entering into force (Federal Gazette II 2001/97). In short, losses that occurred in an Austrian permanent establishment of a German head office between 1990 and 1997 had to be taken into account in Germany, with the recapture procedure – and thus a potential double taxation – applicable only until 1993; for losses that have occurred from 1998 onwards, Austria grants a carry forward irrespective of the amount of foreign profits, but only if double utilization of losses is avoided.

Georg Kofler

Dutch context

The Dutch rules on losses from a permanent establishment are fairly similar to the German rules prevailing at the time of the *Krankenheim* case.

A loss of a permanent establishment (or any other loss a resident incurs on foreign source income) is part of the worldwide income and is therefore deductable from the total income. If the permanent establishment becomes profitable in a later year, the profit from the permanent establishment is also part of the worldwide income. If the taxation of the profit of the permanent establishment is allocated to the State where the permanent establishment is located, the Netherlands will avoid double taxation by using the method of tax exemption. If the taxpayer incurred a loss from the permanent establishment in an earlier year, this loss will be deducted from the profit in the profitable year in the calculation of the tax exemption.

Essentially this works out in the same way as the German system does. The only difference is that the Dutch system takes no account whatsoever of the foreign tax system. The German system does not deduct earlier losses from a permanent establishment if the losses of the permanent establishment cannot be carried over to another year in the State where the permanent establishment is located. This provision is not a part of the coherence of the German tax system (as the ECJ demonstrated in paragraph 51 of this judgment). It is more an exception to the coherence of the system. Therefore, the lack of this special German rule (or something comparable) does not make the Dutch system incoherent.

There is one very small part of the Dutch system that might not be coherent. It was coherent from 1995 until 2006, when both the carry forward of losses and the deduction of losses from a permanent establishment in calculating the tax exemption were not limited in time. However, since 2007, the carry forward of losses has been limited to nine years. Therefore, the question arises whether it is coherent to reintegrate a loss in the calculation of the tax exemption if that loss could not be carried forward had the permanent establishment been subject to Dutch tax.

Rens Paternotte