OPINION OF ADVOCATE GENERAL
POIARES MADURO
delivered on 31 May 2006 [1]

1. Cases relating to national systems of taxation in respect of losses and expenditure of companies belonging to a multinational group raise new and delicate questions in the Community context. [2] They turn on the question whether those systems are compatible with the principles of the EC Treaty designed to secure the establishment and operation of the internal market. Each of these cases raises specific problems and must consequently be examined individually. At the same time, it is necessary to establish clear and consistent case-law on the subject.

2. The Court has recently had occasion to rule, in *Marks & Spencer*, [3] on the compatibility with Community law of the British system of group relief under which a parent company may, in certain circumstances, offset losses incurred by its subsidiaries against its taxable profits. In the present case, the Court is called upon to rule, in the light of the rules on freedom of establishment and the free movement of capital, on a provision of the German legislation on income tax which restricts the ability of a parent company resident in Germany to offset, for tax purposes, losses stemming from write-downs to the book value of subsidiaries of that company established in other Member States.

I — Legal and factual background

3. The facts which gave rise to the case are as follows. By a contract concluded on 6 March 1995, the Kaufhof group sold a company in the group, ITS Reisen GmbH ('ITS'), whose business object is activities in the tourism sector, to Rewe Zentralfinanz eG ('Rewe'). Rewe, having acquired the assets of ITS by a merger agreement, became the universal legal successor of that company.

1 — Original language: Portuguese.

2 — See, to this effect, Case C-168/01 *Bosal* [2003] ECR I-9409 and Case C-471/04 *Keller Holding* [2006] ECR I-2107, and, with regard to loss of income of natural persons, Case C-152/03 *Ritter-Coulais* [2006] ECR I-1711.

3 — Case C-446/03 [2005] ECR I-10837.

4. In 1989, ITS had incorporated a subsidiary in the Netherlands, Kaufhof-Tourism Holdings BV ('KTH'), in which it was the sole shareholder. That subsidiary established a holding company in the same Member State, International Tourism Investment Holding BV ('ITIH'), in which it held 100% of the shares. ITIH also acquired shares in two companies in Belgium, a company in the United Kingdom and a company in Spain.

5. The taxation of companies is governed, in Germany, by the Law on corporation tax (Körperschaftsteuergesetz) ('KStG'), which refers to the relevant provisions of the Law on income tax (Einkommensteuergesetz) ('EStG'). Under Paragraph 1 of the KStG, companies resident in Germany are taxed on the whole of their worldwide profits. Taxable profits represent, in principle, the difference between the undertaking's operating capital at the end of the accounting period and the operating capital at the end of the previous accounting period. Any excess losses may be carried forward or back to other tax years, in accordance with Paragraph 10d of the EStG. In addition, Paragraph 6 of the EStG provides, inter alia, that write-downs to the book value of a shareholding may be taken into account as operating expenditure deductible from taxable profits. That expenditure is calculated by reference to the estimated fall in a company's share price as a result of persistent losses incurred by the company.

6. During the tax years 1993 and 1994, ITS made partial write-downs to the book value of its holding in KTH and adjustments to the value of the book debts owed by the British and Spanish subsidiaries of ITIH. These transactions represent charges amounting to DEM 14 342 499 for 1993 and DEM 32 332 144 for 1994, that is to say, more than DEM 46 million in total.

7. However, the Finanzamt Köln-Mitte (Cologne-Centre tax office) refused to allow these charges as negative income for the purpose of determining Rewe's taxable profits for the two years at issue, on the ground that to do so would be contrary to Paragraph 2a(1) and (2) of the EStG.

8. That provision, headed 'Negative income with foreign connections', reads as follows:

'(1) Negative income

...

2. from a permanent industrial or commercial establishment in a foreign State,

3. (a) from the adoption in the accounts of a lower book value in respect of a shareholding, forming part of operating assets, in an entity that does not have its place of management or its registered office in the country (foreign entity) ...,

...

may be offset only against positive income of the same kind from the same State ...; nor may it be deducted pursuant to Paragraph 10d. Reductions in profits shall be treated in the same way as negative income. To the extent that their negative income cannot be offset under the first sentence, it shall reduce the positive income of the same kind which the taxpayer derives in subsequent periods of assessment in the same State ...

(2) Point 2 of the first sentence of subparagraph (1) shall not apply where the taxpayer establishes that the negative income stems from an industrial or commercial establishment abroad whose object is exclusively or almost exclusively the manufacture or supply of goods, excluding weapons, the extraction of mineral resources or the provision of services of a commercial nature, to the extent that these do not consist in the creation or operation of facilities used for the purposes of tourism or in the letting or leasing of economic assets, including the making available of rights, plans, designs, processes, knowledge and know-how; the direct holding of an interest of at least one quarter of the nominal capital of a company whose object is exclusively or almost exclusively the abovementioned activities, and the financing connected with the holding of such a interest, shall be regarded as the provision of services of a commercial nature where the entity does not have its place of management or its registered office in the country. ... '

9. It is not disputed that, during the two years at issue, ITS had no positive income from its Netherlands subsidiary KTH. Moreover, the conditions for exemption laid down in Paragraph 2a(2) of the EStG were not satisfied: KTH does not pursue any of the privileged activities, described as 'active activities', mentioned in the first sentence of Paragraph 2a(2) of the EStG, nor does it have a direct holding in a company whose object is one of those privileged activities.

10. On the basis of these findings, the Finanzamt Köln-Mitte issued amended

notices of assessment concerning the corporation tax payable by Rewe. Rewe submitted a complaint to the tax authorities. That complaint having been rejected, it brought an action before the Finanzgericht Köln (Finance Court, Cologne) claiming that all the operating expenditure connected with its holdings in the companies established in the Netherlands, the United Kingdom and Spain should be taken into account for tax purposes. In support of that claim, Rewe argues that the application of Paragraph 2a of the EStG constitutes discrimination prohibited under Community law.

11. The referring court also takes that view. It notes that under the applicable law, whereas write-downs to the book value of shareholdings in a German company can in principle be taken into account without restriction for the purpose of determining the taxable profits of the company holding shares in that company, write-downs to the book value of shareholdings in a company established in another Member State can be taken into account only in certain cases, either where the expenditure is offset by positive income from that other Member State or where the conditions as to exemption set out in Paragraph 2a(2) of the EStG are satisfied. It therefore seems clear to the referring court that such a restriction on the deductibility of losses connected with foreign investments constitutes a restriction on freedom of establishment in another Member State and on the free movement of capital, which are protected under Community law.

12. On the strength of that conviction, it decided to stay the proceedings and to refer the following question to the Court for a preliminary ruling:

'Are Article [43 EC], in conjunction with Article [48 EC] and Articles [56 et seq. EC] to be interpreted as precluding a rule which — like the rule laid down in Paragraph 2a(1)(3)(a) and Paragraph 2a(2) of the [EStG] which is at issue in the main proceedings — restricts the immediate deduction for tax purposes of losses stemming from write-downs to the book value of subsidiaries in other countries in the Community, where those subsidiaries pursue passive activities within the meaning of the national provision and/or where the subsidiaries pursue active activities within the meaning of the national provision only through their own second-tier subsidiaries, whilst write-downs to the book value of domestic subsidiaries are possible without these restrictions?'

II — Analysis

A — *The restriction on freedom of establishment*

13. Freedom of establishment, which Article 43 EC grants to Community nationals,

includes the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, under the conditions laid down for its own nationals by the law of the Member State where such establishment is effected. It entails, in accordance with Article 48 EC, for companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the European Community, the right to exercise their activity in the Member State concerned through a subsidiary, branch or agency. [4]

14. It follows from the judgment in *Baars* that a national of a Member State who has a shareholding in a company established in another Member State which gives him definite influence over the company's decisions and allows him to determine its activities is exercising his right of establishment. [5] That is undoubtedly so where, as in the present case, a company such as Rewe has a 100% shareholding in a company established in another Member State which itself holds 100% of the shares in a company with shareholdings in a number of companies in other Member States. It follows that the situation described by the referring court with regard to the losses incurred by Rewe in connection with its holdings in its subsidiary KTH established in the Netherlands and with that subsidiary's holdings in a second-tier foreign subsidiary, is covered by the rules of the Treaty on freedom of establishment.

15. It should be noted 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. [6] It is common ground that the Treaty precludes any 'restriction on departures' in the form of unfavourable treatment imposed, under the legislation of a Member State, on companies resident in that Member State seeking to establish subsidiaries in other Member States.

16. The unfavourable treatment prohibited by the Treaty includes restrictions relating to taxation. According to settled case-law, although direct taxation falls within their competence, the Member States must none the less exercise that competence consistently with Community law. [7]

4 — See, inter alia, Case C-307/97 *Saint-Gobain ZN* [1999] ECR I-6161, paragraph 34.

5 — Case C-251/98 *Baars* [2000] ECR I-2787, paragraph 22. See also Case C-436/00 *X and Y* [2002] ECR I-10829, paragraph 37.

6 — Case C-264/96 *ICI* [1998] I-4695, paragraph 21.

7 — See *Marks & Spencer*, paragraph 29, which reproduces the terms of the judgment in Joined Cases C-397/98 and C-410/98 *Metallgesellschaft and Others* [2001] ECR I-1727, paragraph 37.

17. In terms of the rules at issue in the main proceedings, losses relating to write-downs to the book value of shareholdings in a subsidiary in Germany are to be taken into account without restriction for the purpose of determining the taxable profits of companies subject to taxation. By contrast, losses of the same kind stemming from shareholdings in a subsidiary established in another Member State are deductible by a company which is liable to tax in Germany only subject to certain conditions relating to income or activities.

18. It follows that the tax situation of a company which, like Rewe, has a subsidiary in the Netherlands is less favourable than it would be if that subsidiary was established in Germany. It is true that losses incurred in connection with a holding in a foreign subsidiary could be taken into account if the subsidiary subsequently produced positive income. Nevertheless, even in that case, the parent company in question is deprived of the opportunity to offset its losses immediately. That opportunity, available to companies with national subsidiaries, confers a cash-flow advantage on them. [8] If companies with subsidiaries abroad are deprived of that advantage, it is liable to discourage the establishment of subsidiaries in other Member States.

19. In the light of this difference in treatment, a parent company might therefore be dissuaded from carrying on its activities through the intermediary of first- or second-tier subsidiaries established in other Member States. [9]

20. The German Government contends, however, that the difference in treatment does not constitute discrimination prohibited under the Treaty, inasmuch as the situation of a subsidiary established in Germany is not comparable with the situation of a subsidiary established in another Member State. It states that the Court has recognised that subsidiaries are independent legal persons, each being subject to a tax liability of its own in the territory in which it is located. Losses in respect of write-downs and both debts may therefore be taken into account in the declarations of profits made by those subsidiaries in the Member State in which they are established.

21. That reasoning cannot be upheld. The difference in taxation at issue in the main proceedings does not concern the situation of subsidiaries but the situation of parent companies resident in Germany, according to whether or not they have subsidiaries established in other Member States. It is sufficient to note in this connection, first, that the losses in question are the losses of parent companies and, secondly, that the profits made by subsidiaries do not give rise to a tax liability on the part of the parent company, irrespective of whether the profits in question are generated by subsidiaries that

8 — See, to the same effect, *Marks & Spencer*, paragraph 32.

9 — See, to that effect, *Bosal*, paragraph 27.

are liable to tax in Germany or in other Member States.[10] The difference in treatment regarding parent companies does not therefore depend on whether or not their subsidiaries are taxed separately.

22. It follows from the above that, as the referring court has pointed out, a restriction on the deductibility of expenses stemming from write-downs to shareholdings in subsidiaries established in other Member States, as provided for in Paragraphs 2a(1)(3)(a) and 2a(2) of the EStG, constitutes a restriction on freedom of establishment.

23. Such a restriction can be allowed only if it pursues a legitimate objective compatible with the Treaty and is justified by overriding reasons in the public interest. It is further necessary, in such a case, that its application must be appropriate to ensure the attainment of the objective pursued and must not go beyond what is necessary to attain it.[11]

B — *The justification for the legislation at issue*

24. The German Government puts forward a number of legal arguments in support of the contested measure, based on considerations at once political (the need to ensure the balanced allocation of the power to impose taxes), ethical (the risk of tax evasion through losses being taken into account twice and the risk of tax avoidance), administrative (the need to ensure effective supervision), systemic (the need to ensure the uniformity of the tax system) and economic (the risk of budgetary losses). It claims to find support for these arguments in the judgment in *Marks & Spencer*. The analysis of this reasoning should therefore begin with reference to that case-law.

1. The balanced allocation of the power to impose taxes between Member States

25. In the judgment in *Marks & Spencer*, the Court accepted for the first time that the principle of the balanced allocation of the power to impose taxes between Member States should be taken into account for the purpose of determining whether tax legislation is compatible with the fundamental freedoms.[12] However, it was also careful to specify and delimit the conditions under which that principle applies.

26. In the first place, such a requirement is relevant only at the stage of justifying the

10 — Ibid., paragraph 39.

11 — See, to that effect, Case C-9/02 *De Lasteyrie du Saillant* [2004] ECR I-2409, paragraph 49.

12 — Paragraph 46.

restrictive measure at issue. It cannot be relied on, as the German Government does in the present case, at the stage when a restriction on freedom of establishment is analysed. In the second place, the justification in question has a meaning, in the Community context, that calls for careful delimitation.

27. In this regard, the German Government appears to acknowledge that that requirement could enable certain forms of discrimination to be excluded from the scope of the freedoms of movement. Its argument is based on a *rule of symmetry* between the right to tax a company's profits and the duty to take that company's losses into account. Since, in tax matters, profits and losses are two sides of the same coin, the German tax authorities should not have, when assessing the liability of a parent company resident in German territory to tax, to take account of losses incurred in connection with the activity of a subsidiary established in another Member State, as they are not entitled to tax the profits of that subsidiary. Only such a rule on allocation would secure compliance with the sovereignty accorded to Member States in matters of taxation and with the rules of international tax law.

28. This definition of the requirement of the balanced allocation of the power to impose taxes cannot be accepted. Considered in that light, it does not differ materially from a purely economic justification. Such an interpretation would enable a Member State to refuse as a matter of course to grant a tax advantage to an undertaking on the ground that it had developed a cross-border economic activity which was unlikely to generate tax revenue in that State. Put in that form, such a justification was, moreover, expressly rejected by the Court in the judgment in *Marks & Spencer*. The Court held, with regard to that specific justification, that it must be borne in mind that the reduction in tax revenue cannot be regarded as an overriding reason in the public interest which may be relied on to justify a measure which is in principle contrary to a fundamental freedom. [13]

29. The principle that Member States are free to determine the organisation of their tax system and to allocate their powers of taxation amongst themselves, must of course be taken into account. [14] However, it cannot be denied that the fundamental freedoms impose certain constraints on the Member States in the exercise of their powers in this area. Those constraints essentially require compliance with the obligation not to place taxpayers exercising a cross-border activity at a disadvantage when compared with national taxpayers, even if to do so entails a loss of tax revenue for the State concerned.

13 — *Marks & Spencer*, paragraph 44, reflecting settled case-law cited, in particular, in Case C-319/02 *Manninen* [2004] ECR I-7477, paragraph 49.

14 — See, inter alia, Case C-451/99 *Cura Anlagen* [2002] ECR I-3193, paragraph 40.

30. This view was upheld by the Court inter alia in the judgment in *Bosal*. In that case, the Court held that the Treaty precludes a national provision which makes the deductibility of expenditure related to a Netherlands parent company's shareholding in a subsidiary established in another Member State subject to the condition that such costs be indirectly instrumental in making profits which are taxable in the Netherlands. That view has been challenged on the ground that it is contrary to the principle of the fair allocation of the Member States' power to impose taxes. As the expenditure incurred by the Netherlands parent company was *economically* connected with the profits made by its subsidiary established in another Member State, it would have been *legally* more consistent to regard those costs as foreign expenditure that could be taken into account only in the State in which the profits were made.[15] However, such an analysis does not take sufficient account of the situation of a Community national operating in the wider context of the internal market. That situation must not be considered differently according to the territory in which the tax is imposed in each case; it must be assessed globally. From that point of view, it is clear that a difference in the taxation of parent companies according to whether or not they have foreign subsidiaries cannot be justified on the ground that they have transferred economic resources to a part of the territory of the European Union in which the State in question cannot exercise its power to impose taxes. To take any other view, in the absence of common rules on the subject, would be tantamount to depriving the fundamental freedoms enshrined in the Treaty of all practical effect.

31. Moreover, if the argument of symmetry advanced by the German Government were to be accepted in the area of taxation, there is no apparent reason why it should not be extended to the other areas covered by the rules on the freedoms of movement. Just as the principle of the allocation of the power to impose taxes could be invoked, it would then be possible to rely generally on a principle of allocation of the power to legislate. On that principle, a Member State would be entitled to refuse to take into account cross-border economic situations that might call into question its freedom to legislate. Thus, for example, goods lawfully produced in accordance with conditions imposed by another Member State could be refused entry to a national market on the ground that the goods in question did not meet the legal conditions obtaining in that market. The free movement of goods would then be reduced to a purely formal rule of non-discrimination, consisting of according equal treatment only to goods subject to the rules of the State concerned. Such a result would be completely contrary to the settled case-law of the Court on the subject.[16]

32. That cannot therefore be the scope that should be accorded in the Community

15 — See, to this effect, the Opinion of Advocate General Geelhoed in Case C-374/04 *Test Claimants in Class IV of the ACT Group Litigation*, pending before the Court, points 62 and 63. See also Weber, D., 'The *Bosal Holding* Case: Analysis and Critique', *EC Tax Review*, 2003-4, p. 220, and Wattel, P.J., 'Red Herrings in Direct Tax Cases before the ECJ', *Legal Issues of Economic Integration*, 2004, No 2, pp. 81 to 95, particularly pp. 89 and 90.

16 — See, in this connection, Case 120/78 *Rewe-Zentral* [1979] ECR 649, '*Cassis de Dijon*'.

context to the legitimate requirement of a balanced allocation of the power to impose taxes. While the Court accepted, in the judgment in *Marks & Spencer*, a justification based on that requirement, it was only in relation to the risk of abuse or fraud that might arise, in certain cases, from inadequate coordination of the Member States' powers to impose taxes. In the absence of harmonisation of tax legislation, there is reason to fear that the exercise of free movement might give rise to a veritable 'trade in losses' at Community level. As the Court noted in that judgment, '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'. [17] Economic operators would then be free to surrender their losses to companies established in Member States with the highest rates of taxation, where the tax value of the losses would accordingly be greatest. Such a situation might call into question the neutrality which Community law is required to maintain with regard to national tax systems. [18]

33. In accordance with this principle of neutrality, the right of establishment may not be used by economic operators to gain advantages that are not connected with the exercise of the freedoms of movement. That would, however, be the case if a transfer of activity in the Community were determined solely by tax considerations, irrespective of any intention to seek real establishment and to integrate with the economy of the host society, with the sole aim of circumventing national laws or artificially exploiting differences between those laws. [19] Where a risk of abuse of this kind arises, it may be necessary, as the Court held in *Marks & Spencer*, to apply to the economic activities of companies established in one of those States only the tax rules of that State in respect of both profits and losses. [20] That, in my view, is the true meaning of the requirement of the allocation of the power to impose taxes in the Community context.

34. It must also be shown that such a risk exists. That is why the Court held, in the same judgment, that the justification based on the preservation of the allocation of the power to impose taxes between Member States cannot be separated from two other justifications relating, first, to the risk of losses being taken into account twice and, secondly, to the risk of tax avoidance. It is only in the light of these three justifications, 'taken together', [21] that the Court held that the restrictive provisions at issue could be justified.

17 — Paragraph 46.

18 — See, on this point, my Opinion in *Marks & Spencer*, point 67.

19 — See, to the same effect, the Opinion of Advocate General Léger in Case C-196/04 *Cadbury Schweppes and Cadbury Schweppes Overseas*.

20 — Paragraph 45.

21 — Paragraph 51.

35. It must therefore be determined whether, as the German Government contends, there is a risk of losses being taken into account twice or a risk of tax avoidance in the present case.

2. The risk of losses being taken into account twice

36. The German Government argues that, like the legislation at issue in *Marks & Spencer*, the legislation at issue is necessary to prevent a company benefiting from multiple tax advantages in the form of losses incurred abroad being taken into account twice.

37. That argument is irrelevant in the context of the present case. The losses at issue in this case are not, as in *Marks & Spencer*, losses incurred abroad by independent subsidiaries and subsequently surrendered against the profits of the parent company. They are losses incurred by the parent company as a result of a fall in the value of its shares in foreign subsidiaries. They are not to be confused with losses incurred by the subsidiaries themselves. These two kinds of losses are treated differently for tax purposes. It cannot therefore be held that there is a risk of the *same* losses being taken into account twice because a parent company is allowed to make such a deduction.

38. Even if it were to be accepted that there is an economic link between these two kinds of losses, as the German Government contends, so that taking the losses of the subsidiaries and those of the parent company into account separately could be described as 'taking the losses into account twice', it does not appear that in the present case taking the losses into account twice would have a specific connection with a transfer of activity to another Member State. The alleged 'double advantage' is not confined to companies with cross-border activities. The fact that a parent company with subsidiaries in Germany may offset write-downs to the book value of its shares in those subsidiaries against its taxable profits does not preclude the subsidiaries from taking their own losses into account for tax purposes in that State. There is consequently no connection between losses being taken into account twice and the allocation of the power to impose taxes between Member States, and the fact that losses may be taken into account twice cannot justify a restriction on freedom of establishment.

3. The risk of tax avoidance

39. In this connection, the German Government essentially submits two arguments. First, it contends that German companies tend to transfer certain types of economic

activity to locations outside Germany and beyond the control of the German tax authorities. Second, it points out that the legislation was prompted by the conduct of certain companies, particularly in the tourism sector, in transferring habitually loss-making activities to other Member States solely in order to reduce their taxable profits. Such legislation should be regarded as necessary in order to preclude the possibility of artificial arrangements being entered into.

40. As to the first argument, it is sufficient to point out that the transfer of an activity outside the territory of a Member State does not in itself constitute tax avoidance. There is no doubt that the transfer of an economic activity outside the territory of a Member State may entail a loss of tax revenue for that State. That loss of revenue cannot, however, be attributed to tax avoidance. In that case, it is simply a corollary of the exercise of rights conferred by the fundamental freedoms guaranteed by the Treaty. Tax avoidance or tax evasion cannot be inferred generally from the fact that a company holds shares in subsidiaries established in other Member States and cannot justify a restrictive fiscal measure. [22]

41. As to the second argument, the mere fact that, in a particular economic sector such as tourism, the German tax authorities have established cases of significant and continuing losses incurred by foreign subsidiaries of companies resident in Germany is not sufficient to establish the existence of artificial arrangements. It should be noted that, even if it were accepted that a risk of tax avoidance exists, it must none the less be ascertained whether the measure in question goes beyond what is necessary to attain the objective pursued. [23] However, legislation which, like the legislation at issue, applies *generally* to all situations in which a group's subsidiaries are established, for any reason, in other Member States cannot, without going beyond what is necessary to attain the objectives it claims to pursue, be regarded as justified by the risk of tax avoidance. That results clearly from well established case-law. [24]

42. Moreover, the German Government has not shown the Court how such a risk attached particularly to the formation of subsidiaries abroad rather than to the formation of national subsidiaries. It is likely that, in putting forward that argument, the German Government also wished to draw attention to the limits on its powers of supervision in relation to cross-border transactions.

22 — See, to the same effect, *X and Y*, paragraph 62.

23 — *Marks & Spencer*, paragraph 53.

24 — See *ICI*, paragraph 26.

4. The effectiveness of fiscal supervision

43. According to the German Government, the national tax authorities have very little opportunity to monitor transactions that take place abroad. To apply a principle of territoriality, by excluding negative foreign income from the taxable profits of resident companies, would make it easier for the tax authorities to carry out inspections.

44. That reasoning cannot be accepted. It is true that the Court has held on more than one occasion that the need for effective fiscal supervision may justify a provision that might restrict the fundamental freedoms. [25] It follows that a Member State may apply measures which allow the amount of charges deductible in that State in respect of shareholdings in foreign subsidiaries to be ascertained clearly and precisely. Such a consideration cannot, however, provide any justification for that State to make the deduction subject to different conditions according to whether the holdings relate to subsidiaries situated in that Member State or in other Member States.

45. It should be noted in this connection that the Member States have at their disposal instruments for strengthened collaboration under 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. [26] Those provisions allow the competent authorities of a Member State to request the competent authorities of another Member State to forward any information that may enable them to effect a correct assessment of corporation tax.

46. The German Government contends that, even in the event of fruitful collaboration with the authorities of another Member State, it is often very difficult to monitor foreign transactions and even more difficult to correct inaccurate declarations. It should be pointed out, however, that Directive 77/799 provides for ways of obtaining information comparable to those existing between tax authorities at national level. [27] I should add, first, that in the context of the establishment of the internal market, the relations between the tax authorities of the Member States must be based on mutual trust. [28] There is no reason to suppose in this connection that national tax authorities have any interest in allowing tax arrangements to flourish in their territory that contravene the law of the State to which they are subject. Secondly, there is nothing to prevent the tax authorities concerned from requiring the taxpayer himself to produce the information which they consider necessary to determine

25 — Case C-250/95 *Futura Participations and Singer* [1997] ECR I-2471 and Case C-55/98 *Vestergaard* [1999] ECR I-7641, paragraph 23.

26 — OJ 1977 L 336, p. 15. Directive as amended by Council Directive 2004/56/EC of 21 April 2004 (OJ 2004 L 127, p. 70).

27 — Case C-279/93 *Schumacker* [1995] ECR I-225, paragraph 45.

28 — See, by analogy, as regards the mutual trust Member States must have in each other to carry out inspections in their respective territories, Case C-5/94 *Hedley Lomas* [1996] ECR I-2553, paratraph 19. See also, in the context of the criminal justice systems of the Member States, Joined Cases C-187/01 and C-385/01 *Gözütok and Brügge* [2003] ECR I-1345, paragraph 33.

whether or not the deduction requested should be allowed.[29]

47. In any event, it may appear odd in this connection to take a principle of territoriality of taxation as a basis when as a general rule, under German law, companies are taxed on the whole of their worldwide profits.

5. Ensuring the uniformity of the tax regime

48. The German Government essentially contends that the legislation at issue is a logical corollary of its fiscal policy. It claims that not taking negative foreign income into account in situations such as the one at issue in the present case enables maximum uniformity to be maintained in regard to taxation. Two arguments advanced by that Government may be associated with that justification, one based on observance of the principle of territoriality, the other on ensuring the 'consistency of the tax system'.

49. The principle of territoriality for tax purposes was recognised by the Court in its judgment in *Futura Participations and Singer*. That principle provides that the State concerned may tax parent companies resident on its territory on the whole of their worldwide profits but may tax non-resident subsidiaries solely on the profits from their activities in that State.[30] However, such a principle does not justify refusing an advantage to a resident parent company on the ground that the profits of its non-resident subsidiaries are not taxable.[31] The purpose of the principle is to establish, in the application of Community law, the need to take into account the limits on the powers of taxation of the Member States. In the case of *Futura Participations and Singer*, the Member State concerned could not be required to take foreign losses into account because those losses were connected with non-resident taxpayers' income from a foreign source. That is not the situation in the present case. In this case, granting the advantage does not call into question the exercise of a competing tax jurisdiction. It concerns parent companies resident in Germany which are subject, as such, to unlimited tax liability in that country. There is consequently no justification for refusing that advantage.

50. The 'consistency of the tax system' evokes the concept, more familiar in the Court's case-law, of 'coherence of the tax system'.[32] The German Government states, in this connection, that under double taxation conventions concluded with a number of Member States, dividends paid by subsidiaries established in those States are exempt from tax in Germany. In these circumstances, the German Government

29 — *Vestergaard*, paragraph 26 and the case-law cited therein.

30 — *Marks & Spencer*, paragraph 39.

31 — Ibid., paragraph 40.

32 — See, inter alia, *Manninen*, paragraphs 42 and 43.

considers that it would be logical and consistent not to grant an advantage to the resident parent company in respect of losses connected with its subsidiaries. Such an advantage should be granted only in cases where, in the absence of a bilateral convention providing for exemption, the profits of those subsidiaries are taxable in Germany.

51. I do not agree. Tax conventions designed to prevent double taxation are not capable of eliminating the unfavourable treatment that has been identified. Under the German legislation, losses of the kind at issue in this case are always taken into account when the subsidiary pursues an 'active activity' for the purposes of Article 2a(2) of the EStG. In that case, any dividends paid by that subsidiary may nevertheless be exempt under the terms of such conventions. There is therefore no direct connection between granting the advantage at issue to the parent company and exempting dividends paid by its subsidiary. Consequently, the coherence guaranteed by a double-taxation convention cannot be taken into account in determining whether the contested provision is compatible with Community law. [33]

6. The economic consequences

52. According to the German Government, a challenge to the contested regime would be likely to entail a substantial loss of revenue for the national budget. That Government acknowledges the consistency of the case-law, in terms of which a reduction in tax revenue cannot be regarded as an overriding reason in the general interest which may be relied on to justify a measure which is in principle contrary to a fundamental freedom. [34] However, it suggests that the Court should review its case-law in the light of the fact that tax revenue is an essential source of the income of the Member States and the Community.

33 — See, inter alia, Case C-80/94 *Wielockx* [1995] ECR I-2493, paragraphs 24 and 25.

34 — See, generally, Case 238/82 *Duphar and Others* [1984] ECR 523, paragraph 23, and the Opinion of Advocate General Mancini in that case, and more specifically with regard to taxation, Case C-35/98 *Verkooijen* [2000] ECR I-4071, paragraph 48, and *Manninen*, paragraph 49. The economic aspects of a measure may nevertheless be taken into account when they are inextricably linked with other considerations which are regarded as legitimate. This is borne out, in particular, by Case 72/83 *Campus Oil and Others* [1984] ECR 2727, in which the Court held that national rules which require all importers to purchase a certain proportion of their requirements of petroleum products from a refinery situated in the national territory may be justified in so far as they pursue an essential aim of ensuring a minimum supply of petroleum products at all times, is to be regarded as transcending purely economic considerations (paragraphs 34 and 35). Similarly, the Court has held that the Treaty permits Member States to restrict the freedom to provide medical and hospital services in so far as the maintenance of a treatment facility or medical service on national territory is essential for public health and even the survival of the population (Case C-158/96 *Kohll* [1998] ECR I-1931, paragraph 51). The same line was taken with regard to European citizenship. The Court has recognised, in this connection, that the exercise of the right of residence of citizens of the Union can be subordinated to the 'legitimate interests' of the Member States in protecting their social assistance systems (see Case C-413/99 *Baumbast and R* [2002] ECR I-7091, paragraphs 87 and 90). However, where it appears that the objective of the restrictive measure is budgetary, inasmuch as it is primarily intended to reduce the operating costs of a sickness insurance scheme and not to promote the financial stability of that scheme, the Court has not hesitated to condemn it (see *Duphar and Others*, paragraphs 16 and 23). It follows from this case-law that, while a Member State may legitimately rely on economic or financial considerations when there is a risk that the maintenance of a service essential to its social structure may be seriously impaired, by contrast, aims of a purely economic nature cannot constitute a legitimate basis for a restriction of a fundamental freedom guaranteed by the Treaty.

53. A consideration of this kind may be regarded as legitimate. It is true that the application of Community rules to certain national tax regimes may sometimes have a considerable financial impact. In some cases, that impact may even have a detrimental effect on the financial stability of the State.

54. However, it is for the Member State concerned to establish that there is such an impact in each case and, if it can be shown that there is, it must be taken into account not at the level of justifying the restrictive measure but at the level of the effects of the decision handed down by the Court. It must also be noted that the step of limiting the temporal effects of a ruling of the Court can be taken only in exceptional circumstances, in cases where the State concerned can show that there is a risk of serious economic consequences and where it had legitimate grounds for believing that its conduct was compatible with Community law. [35]

55. In my view, it would be unwise for the Court to include this consideration among the possible grounds for derogating from the fundamental rules of the Treaty. If Member States believe that economic considerations must be able to justify fiscal measures which hinder the freedoms of movement, I am of the opinion that it is for them, and for them alone, to include that provision in the Treaty. It is not for the Court to take the initiative in this connection, for the following three reasons.

56. The first reason is a practical one. If such an economic justification were recognised, the areas in which it was to be recognised would first have to be determined. Should it be limited to taxation or extended to other economic and social areas? Then, parameters and variables would have to be set in order to assess the financial impact of applying the Community rules. Clearly, the Court is very ill-equipped to conduct such an assessment, particularly in view of the economically and fiscally *heterogeneous nature* of the Member States of the Union. I therefore consider that to recognise such a justification, in the absence of clear rules laid down in the Treaty, would give rise to such difficulties that legitimacy of the Court might be affected.

57. The second reason is connected with the effect of that justification. If substantial budgetary losses were to be taken into account for the purpose of justifying a restriction on the fundamental freedoms, it might encourage serious and extensive breaches of Community law. The more persistent the breach, the greater the cost of restoring Community legality and the easier it would become to gain acceptance for a justification of this kind.

35 — Case C-184/99 *Grzelczyk* [2001] ECR I-6193, paragraph 53.

58. Lastly, while it has been clear, since the Community was established, that the establishment of an internal market, involving the removal of barriers to trade of every kind, may result in the loss of certain resources for the Member States, it is nevertheless true that those States benefit from the development of economic activities within the framework of an enlarged internal market.

59. The German Government adds a contemporary justification. It contends that it is even more legitimate to take economic consequences into account now that the Member States are required to observe strict budgetary discipline under the terms of the Stability and Growth Pact. [36] However, that argument does not pay due regard to the letter of the Treaty and the spirit in which the Pact was conceived. It should be noted, first, that under Article 4 EC the coordination of economic policies is to be conducted in accordance with the principle of an open market with free competition. Moreover, an interpretation according to which the application of the Pact would hinder the establishment of the internal market is contrary to the very spirit of the Pact which is expressly designed to encourage the correct operation of Economic and Monetary Union and, through it, the completion of the internal market.

60. It follows from this analysis that all the reasons advanced by the German Government to justify the restrictive measure at issue must be rejected. It must be concluded that, by adopting the contested provision, the German legislature intended essentially to promote the economy of the country by discouraging investment in companies which have their seat in other Member States. As the order for reference points out, an exception to the prohibition on deductibility for this type of investment should be allowed only in the case of activities which benefit the national economy. It is thus clear from the origin of this provision that the German legislature in question deliberately chose to accord less favourable treatment to cross-border situations for the sake of a purely economic objective and to the detriment of the fundamental requirements of the internal market. [37]

C — *The interpretation of the provisions on the free movement of capital*

61. Since the provisions of the Treaty on freedom of establishment preclude the

36 — The Stability and Growth Pact consists of the Resolution of the European Council of 17 June 1997 (OJ 1997 C 236, p. 1), Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies (OJ 1997 L 209, p. 1) and Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure (OJ 1997 L 209, p. 6). These regulations were recently amended by Council Regulation (EC) No 1055/2005 and Council Regulation (EC) No 1056/2005 of 27 June 2005 respectively (OJ 2005 L 174, pp. 1 and 5).

37 — See, to the same effect, *Verkooijen*, paragraphs 47 and 48, and Case C-398/95 *SETTG* [1997] ECR I-3091, paragraphs 22 and 23.

application of the legislation in question in circumstances such as those which apply in the present case, it does not appear to be necessary, for the purpose of settling the dispute in the main proceedings, to consider whether the provisions of the Treaty on the free movement of capital also preclude it.

62. However, it appears that some situations covered by the provision of that legislation at issue may not be subject to the rules on freedom of establishment. That applies, in particular, to the situation of a company which holds shares in a company of another Member State but has neither control of nor influence over that company. [38] In those circumstances, it may be useful to consider in the alternative whether Article 56(1) EC, which prohibits all restrictions on the movement of capital between Member States, may apply.

63. The concept of 'movement of capital' is not defined in the Treaty. However it is settled case-law that, inasmuch as Article 56 EC substantially reproduces the contents of Article 1 of Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty, [39] the nomenclature in respect of movements of capital annexed to Directive 88/361 still has the same indicative value for the purpose of defining the concept of movement of capital as it did before the entry into force of Article 56 EC. [40]

64. Participation in new or existing undertakings with a view to establishing or maintaining lasting economic links is covered in Title I, point 2, of the nomenclature. It follows that the holdings which are the source of the write-downs referred to in the legislation at issue in the present case constitute movements of capital subject to the provisions of the Treaty on freedom of movement.

65. It is therefore indeed necessary to consider whether legislation such as the legislation at issue in the main proceedings constitutes a restriction on the movement of capital.

66. In this regard, it is not apparent from the case-law that this rule is to be judged in accordance with criteria other than those applicable to freedom of establishment. The German tax legislation clearly has the effect of dissuading German companies from investing their capital in certain companies which have their seat in another Member State. [41] Such a rule also has a restrictive

38 — See point 14 of this Opinion.

39 — OJ 1988 L 178, p. 5. Article 67 of the Treaty was repealed by the Treaty of Amsterdam.

40 — See, inter alia, Case C-222/97 *Trummer and Mayer* [1999] ECR I-1661, paragraph 21.

41 — See, by analogy, *Verkooijen* and *Manninen*, paragraphs 34 and 22 respectively.

effect with regard to those companies established in other Member States, in that it constitutes an obstacle to their raising capital in Germany inasmuch as any losses they may generate for German investors do not give rise to the same advantages as investments made in Germany.

67. It follows from the above that that legislation constitutes in principle a restriction on free movement of capital. As the grounds that the Member State concerned might put forward in support of its legislation are essentially the same as those mentioned in connection with the interpretation of the rules on freedom of establishment, they should not be accepted.

III — Conclusion

68. I therefore propose that the Court should rule that Articles 43 EC, 48 EC and 56 EC are to be interpreted as precluding legislation of a Member State which precludes the setting off for tax purposes of losses incurred by a parent company stemming from write-downs to the book value of shareholdings in subsidiaries established in other Member States in certain cases, whilst the setting off for tax purposes of such losses is allowed without restriction where those losses represent write-downs to the book value of shareholdings in subsidiaries established in the Member State where the parent company has its seat.