

Arrêt de la Cour  
**Case C-324/00**

**Lankhorst-Hohorst GmbH**  
**v**  
**Finanzamt Steinfurt**

(Reference for a preliminary ruling from the Finanzgericht Münster)

«(Freedom of establishment – Tax provisions – Corporation tax – Covert distribution of profits – Tax credit – Coherence of the tax system – Tax evasion)»

Opinion of Advocate General Mischo delivered on 26 September 2002 I - 0000      Judgment of the Court (Fifth Chamber), 12 December 2002 I - 0000

Summary of the Judgment

*Freedom of movement for persons – Freedom of establishment – Tax legislation – Tax on company profits – Taxation as disguised dividends of interest paid by a company in return for capital loaned to a major shareholder not in receipt of a tax credit – Provision affecting mainly company shareholders that are foreign parent companies – Not permissible – Whether justifiable – No justification*

(Art. 43 EC) Article 43 EC is to be interpreted as precluding tax legislation of a Member State, which provides that repayments in respect of loan capital which a company has obtained from a shareholder, such as its parent company, with a substantial holding in its capital must, in certain cases, be regarded as a covert distribution of profits, and which applies only to repayments in respect of capital obtained from a shareholder not entitled to tax credit, where, in the large majority of cases, resident parent companies received a tax credit, whereas, as a general rule, non-resident parent companies do not. Such a difference in treatment between resident subsidiary companies according to the seat of their parent company makes it less attractive for companies established in other Member States to exercise freedom of establishment and they may, in consequence, refrain from acquiring, creating or maintaining a subsidiary in the State which adopts that measure and constitutes an obstacle to freedom of establishment which is, in principle, prohibited by Article 43 EC. That legislation cannot be justified by reasons linked to the risk of tax evasion, where it does not have the specific purpose of preventing wholly artificial arrangements, designed to circumvent national tax legislation, but applies generally to any situation in which the parent company has its seat, for whatever reason, outside the Member State, since such a situation does not, of itself, entail a risk of tax evasion; nor can it be justified by the need to ensure the coherence of a tax system, there being no direct link between the less favourable tax treatment suffered by the subsidiary of a non-resident parent company and any tax advantage to offset such treatment. see paras 27-28, 32, 36-37, 40, 42, 45, operative part

JUDGMENT OF THE COURT (Fifth Chamber)  
12 December 2002 (1)

((Freedom of establishment – Tax provisions – Corporation tax – Covert distribution of profits – Tax credit – Coherence of the tax system – Tax evasion))

In Case C-324/00,

REFERENCE to the Court under Article 234 EC by the Finanzgericht Münster (Germany) for a preliminary ruling in the proceedings pending before that court between

**Lankhorst-Hohorst GmbH**

and

**Finanzamt Steinfurt,**

on the interpretation of Article 43 EC,

THE COURT (Fifth Chamber),,

composed of: M. Wathelet (Rapporteur), President of the Chamber, C.W.A. Timmermans, D.A.O. Edward, P. Jann and A. Rosas, Judges,

Advocate General: J. Mischo,

Registrar: L. Hewlett, Principal Administrator,

after considering the written observations submitted on behalf of:

?the German Government, by W.-D. Plessing and T. Jürgensen, acting as Agents,

?the Danish Government, by J. Molde, acting as Agent,

?the United Kingdom Government, by J.E. Collins, acting as Agent, assisted by R. Singh, Barrister,

?the Commission of the European Communities, by R. Lyal, acting as Agent, assisted by R. Bierwagen, Rechtsanwalt,

having regard to the Report for the Hearing,

after hearing the oral observations of Lankhorst-Hohorst GmbH, represented by J. Schirmer and J.A. Schirmer, Steuerberater; of the German Government, by W.-D. Plessing and G. Müller-Gatermann, acting as Agent; of the United Kingdom Government, represented by J.E. Collins, assisted by R. Singh; and of the Commission, represented by R. Lyal, assisted by R. Bierwagen, at the hearing on 30 May 2002,

after hearing the Opinion of the Advocate General at the sitting on 26 September 2002,

gives the following

## **Judgment**

1 By order of 21 August 2000, received at the Court on 4 September 2000, the Finanzgericht (Finance Court) Münster referred to the Court of Justice for a preliminary ruling under Article 234 EC a question on the interpretation of Article 43 EC.

2 That question was raised in proceedings brought by Lankhorst-Hohorst GmbH (hereinafter Lankhorst-Hohorst), a company established in Rheine, Germany, against the Finanzamt Steinfurt, a German tax authority, concerning payment of corporation tax for 1997 and 1998.

**The national legislation**

3 Paragraph 8a of the Körperschaftsteuergesetz (Law on corporation tax), in the version in force from 1996 to 1998 (hereinafter the KStG), is headed Capital borrowed from shareholders. Paragraph 8a(1) provides as follows: Repayments in respect of loan capital which a company limited by shares subject to unlimited taxation has obtained from a shareholder not entitled to corporation tax credit which had a substantial holding in its share or nominal capital at any point in the financial year shall be regarded as a covert distribution of profits,...

2. where repayment calculated as a fraction of the capital is agreed and the loan capital is more than three times the shareholder's proportional equity capital at any point in the financial year, save where the company limited by shares could have obtained the loan capital from a third party under otherwise similar circumstances or the loan capital constitutes borrowing to finance normal banking transactions. ...

4 It is apparent from the order for reference that there is no entitlement to corporation tax credit, first, for non-resident shareholders and, second, for corporations governed by German law which are exempt from corporation tax, namely legal persons governed by public law and those carrying on business in a specific field or performing tasks which should be encouraged.

The main proceedings and the question referred for a preliminary ruling

5 Lankhorst-Hohorst sells boating equipment, goods for watersports, leisure and craft items, leisure and work clothing, furnishings, hardware and similar goods. In August 1996 its share capital was increased to DEM 2 000 000.

6 The sole shareholder in Lankhorst-Hohorst is Lankhorst-Hohorst BV (hereinafter LH BV), which has its registered office in the Netherlands, at Sneek. The sole shareholder in LH BV is Lankhorst Taselaar BV (hereinafter LT BV), which also has its registered office in the Netherlands, at Lelystad.

7 By agreement of 1 December 1996 LT BV granted Lankhorst-Hohorst a loan of DEM 3 000 000, repayable over 10 years in annual instalments of DEM 300 000 from 1 October 1998 (hereinafter the loan). The variable interest rate was 4.5% until the end of 1997. Interest was payable at the end of each year. LT BV received interest payments of DEM 135 000 in 1997 and DEM 109 695 in 1998.

8 The loan, which was intended as a substitute for capital, was accompanied by a *Patronatserklärung* (letter of support) under which LT BV waived repayment if third party creditors made claims against Lankhorst-Hohorst.

9 The loan enabled Lankhorst-Hohorst to reduce its bank borrowing from DEM 3 702 453.59 to DEM 911 174.70 and thus to reduce its interest charges.

10 For 1996, 1997 and 1998, the balance sheet of Lankhorst-Hohorst showed a deficit not covered by equity capital; in 1998 it amounted to DEM 1 503 165.

11 In its corporation tax assessment notices of 28 June 1999, in respect of the years 1997 and 1998, the Finanzamt Steinfurt took the view that the interest paid to LT BV was equivalent to a covert distribution of profits within the meaning of Paragraph 8a of the KStG and taxed Lankhorst-Hohorst on them as such at the rate of 30%.

12 According to the Finanzgericht, the exception laid down in Paragraph 8a(1), Head 2, of the KStG for cases in which the company in question could also have obtained the loan capital from a third party under identical terms could not apply in the main proceedings. Having regard to the over-indebtedness of Lankhorst-Hohorst and its inability to provide security, it could not in fact have obtained a similar loan from a third party, granted without security and covered by a *Patronatserklärung*.

13 By decision of 14 February 2000, the Finanzamt Steinfurt rejected as unfounded the objection lodged by Lankhorst-Hohorst against the corporation tax assessment notices.

14 In support of its action before the national court, Lankhorst-Hohorst stated that the grant of the loan by LT BV constituted a rescue attempt and that the interest repayments could not be classified as a covert distribution of profits. It also submitted that Paragraph 8a of the KStG was discriminatory in the light of the treatment accorded to German shareholders, who are entitled to the tax credit, unlike companies such as LH BV and LT BV which have

their registered offices in the Netherlands. Consequently, Paragraph 8a infringed Community law and Article 43 EC in particular.

15 Lankhorst-Hohorst added that regard should be had to the purpose of Paragraph 8a of the KStG, which is to prevent tax evasion by companies limited by shares. In the present case, however, the loan was granted with the sole objective of minimising the expenses of Lankhorst-Hohorst and achieving significant savings in regard to bank interest charges. Lankhorst-Hohorst claimed in that regard that, prior to reduction of the bank loan, interest charges had been twice the amount subsequently paid to LT BV. This is accordingly not a case of a shareholder with no right to a tax credit seeking to avoid tax chargeable on true distributions of profits by arranging for the payment of interest to itself.

16 The Finanzamt Steinfurt submitted that the application of Paragraph 8a of the KStG may indeed exacerbate the situation of companies in difficulty, but the German legislature had taken that circumstance into account in providing for an exemption in the third sentence of Paragraph 8a, Head 2, of the KStG. That exemption is not, however, applicable in the present case. The Finanzamt also submitted that the wording of Paragraph 8a does not suggest that the existence of tax evasion is one of the conditions for its application, and the Finanzgericht has confirmed that submission.

17 Nevertheless, the Finanzamt submitted that Paragraph 8a of the KStG is not contrary to the Community principle of non-discrimination. Many countries have adopted provisions with a similar objective, particularly in order to combat abuses.

18 The Finanzamt also submitted that the distinction made in Paragraph 8a of the KStG ? between persons who are entitled to tax credit and those who are not ? does not entail disguised discrimination on the basis of nationality, since Paragraph 5, relating to exemption from corporation tax, read together with Paragraph 51 of the KStG, also excludes several categories of German taxpayers from entitlement to tax credit.

19 The Finanzamt contends in addition that the principle of once-only levy of national taxation and the coherence of the German tax system justify the application of Paragraph 8a of the KStG in the circumstances of the main proceedings.

20 The Finanzgericht Münster has expressed doubts, in the light of the case-law of the Court of Justice, as to the compatibility of Paragraph 8a of the KStG with Article 43 EC (see, inter alia, Case 270/83 *Commission v France* [1986] ECR 273; Case C-311/97 *Royal Bank of Scotland* [1999] ECR I-2651; Case C-294/97 *Eurowings Luftverkehr* [1999] ECR I-7447). It observes that, according to the case-law of the Court, a national of a Member State who has a holding in the capital of a company established in another Member State which gives him a definite influence over the company's decisions is exercising his right of establishment (Case C-251/98 *Baars* [2000] ECR I-2787).

21 According to the Finanzgericht, there is an infringement of the right of establishment where the less favourable tax treatment of a subsidiary is based solely on the fact that the parent company has its seat in a Member State other than that in which the subsidiary is established and there is no objective justification for such treatment.

22 The Finanzgericht observes in that regard that the rule in Paragraph 8a of the KStG is not directly linked to nationality, but to whether the taxable person enjoys a tax credit.

23 It states that, in those circumstances, a shareholder which has its seat outside Germany is systematically subject to the rule in Paragraph 8a of the KStG, whereas, of shareholders established in Germany, only a clearly defined category of taxable persons is exempt from corporation tax and, in consequence, is not entitled to the tax credit. However, the latter category of corporations is not in a position comparable to that of the parent company of Lankhorst-Hohorst.

24 As regards the justification for applying Paragraph 8a of the KStG, the Finanzgericht observes that considerations relating to the coherence of the tax system may be relied on only where there is a direct link between a fiscal advantage granted to a taxable person and the taxation of that same taxable person (judgment of the Bundesfinanzhof of 30 December 1996, I B 61/96, BStBl. II 1997, 466, and *Eurowings Luftverkehr*, cited above, paragraph 42). In the present case, it can discern no such link.

25 In the circumstances, the Finanzgericht decided to stay proceedings and to refer the following question to the Court for a preliminary ruling: Is the requirement of freedom of establishment for nationals of a Member State in the territory of another Member State laid down in Article 43 of the Treaty of 10 November 1997 establishing the European Community to be interpreted as precluding the national rule contained in Paragraph 8a of the German Körperschaftsteuergesetz?

Reply of the Court

26 It should be remembered that, according to settled case-law, although direct taxation falls within their competence, Member States must none the less exercise that competence consistently with Community law and, in particular, avoid any discrimination on grounds of nationality (Case C-80/94 *Wielockx* [1995] ECR I-2493, paragraph 16, Case C-107/94 *Asscher* [1996] ECR I-3089, paragraph 36, *Royal Bank of Scotland*, cited above, paragraph 19, *Baars*, cited above, paragraph 17, and Joined Cases C-397/98 and C-410/98 *Metallgesellschaft and Others* [2001] ECR I-1727, paragraph 37).

The existence of an obstacle to freedom of establishment

27 Article 8a(1), Head 2, of the KStG applies only to repayments in respect of loan capital which a company limited by shares subject to unlimited taxation has obtained from a shareholder not entitled to corporation tax credit. As regards the taxation of interest paid by subsidiary companies to their parent companies in return for loan capital, such a restriction introduces a difference in treatment between resident subsidiary companies according to whether or not their parent company has its seat in Germany.

28 In the large majority of cases, resident parent companies receive a tax credit, whereas, as a general rule, non-resident parent companies do not. As stated in paragraph 4 of this judgment, corporations incorporated under German law which are exempt from corporation tax and, consequently, not entitled to tax credit are essentially legal persons governed by public law and those carrying out business in a specific field or performing tasks which should be encouraged. The situation of a company such as the parent company of Lankhorst-Hohorst, which is carrying on a business for profit and is subject to corporation tax, cannot validly be compared to that of the latter category of corporations.

29 It is therefore apparent that, under Article 8a(1), Head 2, of the KStG, interest paid by a resident subsidiary on loan capital provided by a non-resident parent company is taxed as a covert dividend at a rate of 30%, whereas, in the case of a resident subsidiary whose parent company is also resident and receives a tax credit, interest paid is treated as expenditure and not as a covert dividend.

30 In reply to a question put by the Court, the German Government stated that the interest paid by a resident subsidiary to its, likewise resident, parent company on a loan of capital from the parent company is also treated for tax purposes as a covert dividend in a case where the parent company has issued a *Patronatserklärung*.

31 That fact is not, however, such as to affect the existence of a treatment which differs according to the seat of the parent company. The classification of an interest payment as the covert distribution of profits results, in the case of a resident company which has received a loan from a non-resident parent company, solely and directly from application of Paragraph 8a(1), Head 2, of the KStG, irrespective of whether or not a *Patronatserklärung* has been issued.

32 Such a difference in treatment between resident subsidiary companies according to the seat of their parent company constitutes an obstacle to the freedom of establishment which is, in principle, prohibited by Article 43 EC. The tax measure in question in the main proceedings makes it less attractive for companies established in other Member States to exercise freedom of establishment and they may, in consequence, refrain from acquiring, creating or maintaining a subsidiary in the State which adopts that measure.

Justification for the obstacle to freedom of establishment

33 It must still be established whether a national measure such as that in Paragraph 8a(1), Head 2, of the KStG pursues a legitimate aim which is compatible with the Treaty and is justified by pressing reasons of public interest. In that event, it must also be such as to

ensure achievement of the aim in question and not go beyond what is necessary for that purpose (see, in particular, Case C-250/95 *Futura Participations and Singer* [1997] ECR I-2471, paragraph 26, and Case C-35/98 *Verkooijen* [2000] ECR I-4071, paragraph 43).

34 First, the German, Danish and United Kingdom Governments and the Commission submit that the national measure at issue in the main proceedings is intended to combat tax evasion in the form of the use of thin capitalisation or hidden equity capitalisation. All things being equal, it is more advantageous in terms of taxation to finance a subsidiary company through a loan than through capital contributions. In such a case, the profits of the subsidiary are transferred to the parent company in the form of interest, which is deductible in calculating the subsidiary's taxable profits, and not in the form of a non-deductible dividend. Where the subsidiary and the parent company have their seats in different countries, the tax debt is therefore likely to be transferred from one country to the other.

35 The Commission adds that Paragraph 8a(1), Head 2, of the KStG does indeed provide for an exception in the case of a company which proves that it could have obtained the loan capital from a third party on the same conditions, and fixes the permissible amount of loan capital in comparison with equity capital. However, the Commission points to the existence, in the present case, of a risk of double taxation since the German subsidiary is subject to German taxation on interest paid, whereas the non-resident parent company must still declare the interest received as income in the Netherlands. The principle of proportionality requires that the two Member States in question reach an agreement in order to avoid double taxation.

36 It is settled law that reduction in tax revenue does not constitute an overriding reason in the public interest which may justify a measure which is in principle contrary to a fundamental freedom (see Case C-264/96 *ICI* [1998] ECR I-4695, paragraph 28; *Verkooijen*, cited above, paragraph 59; *Metallgesellschaft and Others*, cited above, paragraph 59, and Case C-307/97 *Saint-Gobain ZN* [1999] ECR I-6161, paragraph 51).

37 As regards more specifically the justification based on the risk of tax evasion, it is important to note that the legislation at issue here does not have the specific purpose of preventing wholly artificial arrangements, designed to circumvent German tax legislation, from attracting a tax benefit, but applies generally to any situation in which the parent company has its seat, for whatever reason, outside the Federal Republic of Germany. Such a situation does not, of itself, entail a risk of tax evasion, since such a company will in any event be subject to the tax legislation of the State in which it is established (see, to that effect, *ICI*, cited above, paragraph 26).

38 Moreover, according to the findings of the national court itself, no abuse has been proved in the present case, the loan having been made in order to assist Lankhorst-Hohorst by reducing the interest burden resulting from its bank loan. Furthermore it is clear from the case-file that Lankhorst-Hohorst made a loss in the 1996, 1997 and 1998 financial years and its loss largely exceeded the interest paid to LT BV.

39 Second, the German and United Kingdom Governments submit that Paragraph 8a(1), Head 2, of the KStG is also justified by the need to ensure the coherence of the applicable tax systems. More specifically, that provision is in accordance with the arm's length principle, which is internationally recognised and pursuant to which the conditions upon which loan capital is made available to a company must be compared with the conditions which the company could have obtained for such a loan from a third party. Article 9 of the Model Convention of the Organisation for Economic Cooperation and Development (OECD) reflects that concern in providing for inclusion in profits for tax purposes where transactions are concluded between linked companies on conditions which do not correspond to market conditions.

40 In Case C-204/90 *Bachmann* [1992] I-249 and in Case C-300/90 *Commission v Belgium* [1992] ECR I-305 the Court held that the need to ensure the coherence of the tax system may justify rules which restrict the free movement of persons.

41 However, that is not the case with the rules at issue here.

42 Although in *Bachmann* and *Commission v Belgium* , since the taxpayer was one and the same person, there was a direct link between deductibility of pension and life assurance contributions and taxation of the sums received under those insurance contracts and preservation of that link was necessary to safeguard the coherence of the relevant tax system, there is no such direct link where, as in the present case, the subsidiary of a non-resident parent company suffers less favourable tax treatment and the German Government has not pointed to any tax advantage to offset such treatment (see, to that effect, *Wielockx* , paragraph 24; Case C-484/93 *Svensson and Gustavsson* [1995] ECR I-3955, paragraph 18; *Eurowings Luftverkehr* , paragraph 42; *Verkooijen* , paragraphs 56 to 58, and *Baars* , paragraph 40).

43 Third, the United Kingdom Government, referring to paragraph 31 of the judgment in *Futura Participations and Singer* , submits that the national measure at issue here could be justified by the concern to ensure the effectiveness of fiscal supervision.

44 It is enough to find in that regard that no argument has been put to the Court to show how the classification rules contained in Paragraph 8a(1), Head 2, of the KStG are of such a nature as to enable the German tax authorities to supervise the amount of taxable income.

45 Having regard to all the foregoing considerations, the answer to be given to the national court must be that Article 43 EC is to be interpreted as precluding a measure such as that contained in Paragraph 8a(1), Head 2, of the KStG.

#### Costs

46 The costs incurred by the German, Danish and United Kingdom Governments and by the Commission, which have submitted observations to the Court, are not recoverable. 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.

On those grounds,

#### THE COURT (Fifth Chamber),

in answer to the question referred to it by the Finanzgericht Münster by order of 21 August 2000, hereby rules:

Wathelet

Timmermans

Edward

Jann

Rosas

Delivered in open court in Luxembourg on 12 December 2002.

R. Grass

M. Wathelet

Registrar

President of the Fifth Chamber