Case C-414/06

Lidl Belgium GmbH & Co. KG

v

Finanzamt Heilbronn

(Reference for a preliminary ruling from the Bundesfinanzhof)

(Freedom of establishment – Direct taxation – Taking account of losses incurred by a permanent establishment situated in a Member State and belonging to a company which has its registered office in another Member State)

Summary of the Judgment

1. *Freedom of movement for persons – Freedom of establishment – Free movement of capital – Provisions of the Treaty – Scope*

(Arts 43 EC and 56 EC)

2. *Freedom of movement for persons – Freedom of establishment – Provisions of the Treaty – Scope*

(Art. 43 EC)

3. *Freedom of movement for persons – Freedom of establishment – Tax legislation – Corporation tax*

(Art. 43 EC)

1. The creation and the outright ownership by a natural or legal person established in a Member State of a permanent establishment not having a separate legal personality situated in another Member State falls within the scope of application ratione materiae of Article 43 EC. Even if it were to be accepted that, by not allowing a resident company to deduct from its tax base losses relating to a permanent establishment belonging to it and situated in another Member State, the tax regime has restrictive effects on the free movement of capital, such effects would have to be seen as an unavoidable consequence of any restriction on freedom of establishment and they do not justify an examination of that regime in the light of Article 56 EC.

(see paras 15-16)

2. The provisions of the EC Treaty concerning freedom of establishment, which 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, also apply where a company established in a Member State carries on business in another Member State through a permanent establishment, as defined in a relevant double taxation convention, which constitutes, under tax convention law, an autonomous entity.

That definition of a permanent establishment as an autonomous fiscal entity is consonant with international legal practice as reflected in the model tax convention drawn up by the Organisation

for Economic Cooperation and Development (OECD). For the purposes of the allocation of fiscal competence, it is not unreasonable for the Member States to draw guidance from international practice and, particularly, the model conventions drawn up by the OECD.

(see paras 19-22)

3. Article 43 EC does not preclude a situation in which a company established in a Member State cannot deduct from its tax base losses relating to a permanent establishment belonging to it and situated in another Member State, to the extent that, by virtue of a double taxation convention, the income of that establishment is taxed in the latter Member State where those losses can be taken into account in the taxation of the income of that permanent establishment in future accounting periods.

It is true that such a tax regime involves a restriction on the freedom of establishment, since the tax situation of a company which has its registered office in one Member State and has a permanent establishment in another Member State is less favourable than it would be if the latter were to be established in the first Member State. By reason of that difference in tax treatment, a resident company could be discouraged from carrying on its business through a permanent establishment situated in another Member State.

Nevertheless, such a tax regime can, in principle, be justified in the light of the need to safeguard the allocation of the power to tax between the Member States and the need to prevent the danger that the same losses will be taken into account twice which, taken together, pursue legitimate objectives compatible with the Treaty and thus constitute overriding reasons in the public interest, provided that the regime is proportionate to those objectives.

With respect to the need to safeguard the allocation of the power to tax between the Member States, the Member State in which the registered office of the company to which the permanent establishment belongs is situated would, in the absence of a double taxation convention, have the right to tax the profits generated by such an entity. Consequently, the objective of preserving the allocation of the power to impose taxes between the two Member States concerned, which is reflected in the provisions of the convention, is capable of justifying the tax regime at issue, since it safeguards symmetry between the right to tax profits and the right to deduct losses. In that connection, where a double taxation convention has given the Member State in which the permanent establishment is situated the power to tax the profits of that establishment, to give the principal company the right to elect to have the losses of that permanent establishment taken into account in the Member State in which it has its seat or in another Member State would seriously undermine a balanced allocation of the power to impose taxes between the Member States concerned.

As regards the danger that the same losses will be used twice, it is possible that a company might deduct, in the Member State in which its seat is situated, losses incurred by a permanent establishment belonging to it and situated in another Member State and that, despite such offsetting, the same losses might be taken into account subsequently in the Member State in which the permanent establishment is situated, when that establishment generates profits, thereby preventing the Member State in which the principal company has its seat from taxing that profit.

(see paras 25-26, 33, 36, 39, 42, 52-54, operative part)

JUDGMENT OF THE COURT (Fourth Chamber)

15 May 2008 (*)

(Freedom of establishment – Direct taxation – Taking account of losses incurred by a permanent establishment situated in a Member State and belonging to a company which has its registered office in another Member State)

In Case C?414/06,

REFERENCE for a preliminary ruling under Article 234 EC by the Bundesfinanzhof (Germany), made by decision of 28 June 2006, received at the Court on 11 October 2006, in the proceedings

Lidl Belgium GmbH & Co. KG

v

Finanzamt Heilbronn,

THE COURT (Fourth Chamber),

composed of K. Lenaerts, President of the Chamber, G. Arestis, R. Silva de Lapuerta (Rapporteur), E. Juhász and T. von Danwitz, Judges,

Advocate General: E. Sharpston,

Registrar: B. Fülöp, Administrator,

having regard to the written procedure and further to the hearing on 29 November 2007,

after considering the observations submitted on behalf of:

– Lidl Belgium GmbH & Co. KG, by W. Schön and M. Schaden, Rechtsanwälte,

– Finanzamt Heilbronn, by C.-F. Vees, acting as Agent,

– the German Government, by M. Lumma, C. Blaschke and H. Kube, acting as Agents,

– the Greek Government, by M. Papida, I. Pouli and K. Georgiadis, acting as Agents,

– the French Government, by G. de Bergues and J.-C. Gracia, acting as Agents,

– the Netherlands Government, by H.G. Sevenster, P. van Ginneken and M. de Grave, acting as Agents,

– the Finnish Government, by J. Heliskoski and J. Himmanen, acting as Agents,

– the Swedish Government, by K. Wistrand and S. Johannesson, acting as Agents,

– the United Kingdom Government, by Z. Bryanston-Cross, acting as Agent, and S. Lee, Barrister,

– the Commission of the European Communities, by R. Lyal and W. Mölls, acting as Agents,

after hearing the Opinion of the Advocate General at the sitting on 14 February 2008,

gives the following

Judgment

1 This reference for a preliminary ruling concerns the interpretation of Articles 43 EC and 56 EC.

2 The reference was made in proceedings between Lidl Belgium GmbH & Co. KG ('Lidl Belgium') and the Finanzamt Heilbronn ('the Finanzamt') relating to the tax treatment by the German competent authorities of losses incurred by a permanent establishment of Lidl Belgium situated in Luxembourg.

Legal context

3 The second subparagraph of the first paragraph of Article 2 of the Convention between the Grand Duchy of Luxembourg and the Federal Republic of Germany for the avoidance of double taxation and relating to mutual administrative and legal assistance in the fields of taxation of income and capital and of business and land taxation of 23 August 1958 (BGBl. II 1959, p. 1270), as amended by the additional protocol of 15 June 1973 ('the Convention'), provides that the expression 'permanent establishment' is to mean 'a fixed place of business at which the undertaking carries on all or part of its activities'.

4 The second subparagraph, point (a), of the first paragraph of Article 2 of the Convention lists a number of types of premises which are to be treated as being a permanent establishment for the purposes of the Convention.

5 Article 5 of the Convention provides:

'1. Where a person residing in one of the Contracting States receives income in his capacity as owner or co-owner of an industrial or commercial undertaking the activities of which extend to the territory of the other Contracting State, that income shall be taxable in that other State only in so far as it is attributable to a permanent establishment situated in the territory of that State.

2. In this connection, the income which is to be attributed to the permanent establishment is that income which it would have received had it constituted a separate undertaking carrying out the same or similar activities in the same or similar conditions and carrying on business in the same way as an independent undertaking.

…'

6 Article 6(1) of the Convention states:

'Where an undertaking of one of the Contracting States, by reason of its participation in the

management or financial structure of an undertaking of the other State, agrees economic or financial conditions with that undertaking which differ from those which would have been agreed with an independent undertaking, or imposes such conditions on it, the income which would in the normal case have been received by one of those undertakings, but which by reason of those conditions was not in fact so paid, may be included in the income of that undertaking and taxed accordingly.'

7 Article 20 of the Convention states:

'1. Where, in accordance with the preceding articles, the State of residence has the right to tax income or capital, the other State shall not tax such income or capital. …

2. There shall, unless paragraph 3 applies, be excluded from the tax base of the State of residence any income and capital which is taxable in the other State by virtue of the preceding articles. However, taxes on income or capital which may be taxed in the State of residence shall be levied at the rate applicable to the taxpayer's total income or total capital.

…'

The main proceedings and the question referred for a preliminary ruling

8 Lidl Belgium is a member of the Lidl and Schwarz group and carries on business as a distributor of goods. Lidl Belgium, which had initially developed its business on the Belgian market, was given the further task of establishing itself in Luxembourg from 1999. To that end, Lidl Belgium created a permanent establishment there.

9 Lidl Belgium is a limited partnership with its registered office in Germany, the partners of which include Lidl Belgium Beteiligungs-GmbH, as a limited partner, and Lidl Stiftung & Co. KG, as a general partner.

10 During the 1999 accounting period, which is the period at issue in the main proceedings, Lidl Belgium's permanent establishment in Luxembourg incurred a loss.

11 When calculating its revenue for tax purposes, Lidl Belgium sought to deduct that loss from the amount of its tax base. The Finanzamt disallowed the deduction of that loss on the basis, inter alia, of the exemption of income relating to that permanent establishment by virtue of the provisions of the Convention.

12 On 30 June 2004, the Finanzgericht Baden-Würtemberg (Finance Court, Baden-Würtemberg), before which Lidl Belgium had brought proceedings, dismissed the latter's action against the decision of the Finanzamt.

13 An appeal having been brought before it by Lidl Belgium, the Bundesfinanzhof (Federal Finance Court) decided to stay the proceedings and to refer the following question to the Court for a preliminary ruling:

'Is it compatible with Articles 43 EC and 56 EC for a German company with income from industrial or commercial activities to be precluded, when calculating its income, from deducting losses from a permanent establishment in another Member State (in this case, the Grand Duchy of Luxembourg) on the ground that, according to [the Convention], the corresponding income from such a permanent establishment is not subject to taxation in Germany?'

The question referred for a preliminary ruling

14 By its question, the national court essentially asks whether Articles 43 EC and 56 EC preclude a national tax regime which does not allow a resident company, for the purposes of determining its profits and calculating its taxable income, to deduct losses incurred in another Member State by a permanent establishment belonging to it, when that tax regime does allow losses incurred by a resident permanent establishment to deduct those losses.

The scope of application of Articles 43 EC and 56 EC

15 As the national court has referred to each of the provisions mentioned above in the question referred, it should be noted that the creation and the outright ownership by a natural or legal person established in a Member State of a permanent establishment not having a separate legal personality situated in another Member State falls within the scope of application *ratione materiae* of Article 43 EC.

16 Even if it were to be accepted that the tax regime at issue in the main proceedings has restrictive effects on the free movement of capital, such effects would have to be seen as an unavoidable consequence of any restriction on freedom of establishment and they do not justify an examination of that regime in the light of Article 56 EC (see, to that effect, Case C-196/04 *Cadbury Schweppes and Cadbury Schweppes Overseas* [2006] ECR I-7995, paragraph 33; Case C-452/04 *Fidium Finanz* [2006] ECR I-9521, paragraphs 48 and 49; and Case C-524/04 *Test Claimants in the Thin Cap Group Litigation* [2007] ECR I-2107, paragraph 34).

17 Accordingly, the tax regime at issue in the main proceedings must be assessed in the light of Article 43 EC.

Whether a restriction on the freedom of establishment exists

18 It should be noted at the outset that freedom of establishment entails 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 other Member States through a subsidiary, branch or agency (see Case C-307/97 *Saint?Gobain ZN* [1999] ECR I-6161, paragraph 35; Case C-141/99 *AMID* [2000] ECR I-11619, paragraph 20; and Case C-471/04 *Keller Holding* [2006] ECR I-2107, paragraph 29).

19 Even though, according to their wording, the provisions of the EC 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 (see, inter alia, Case C-264/96 *ICI* [1998] ECR I-4695, paragraph 21, and Case C-298/05 *Columbus Container Services* [2007] ECR I-0000, paragraph 33).

20 Those considerations also apply where a company established in a Member State carries on business in another Member State through a permanent establishment.

21 Indeed, and as is shown by the provisions of the Convention, a permanent establishment constitutes, under tax convention law, an autonomous entity. Thus, those to whom the Convention applies comprise, in accordance with Article 2 of the Convention, not only natural and legal persons, but also all those types of permanent establishment which are listed in the second subparagraph, point (a), of the first paragraph of Article 2, in a manner which distinguishes them from other categories of entity listed in the second subparagraph, point (b), of that article, which are excluded from the definition of permanent establishment under the Convention.

22 That definition of a permanent establishment as an autonomous fiscal entity is consonant with international legal practice as reflected in the model tax convention drawn up by the Organisation for Economic Cooperation and Development (OECD), in particular Articles 5 and 7 thereof. The Court has already held that, for the purposes of the allocation of fiscal competence, it is not unreasonable for the Member States to draw guidance from international practice and, particularly, the model conventions drawn up by the OECD (see Case C?336/96 *Gilly* [1998] ECR I-2793, paragraph 31, and Case C-513/03 *van Hilten-van der Heijden* [2006] ECR I-1957, paragraph 48).

23 As regards the tax regime at issue in the main proceedings, it must be pointed out that a provision which allows losses incurred by a permanent establishment to be taken into account in calculating the profits and taxable income of the principal company constitutes a tax advantage.

24 However, the provisions of that tax regime do not grant such a tax advantage where the losses are incurred by a permanent establishment situated in a Member State other than that in which the principal company is established.

25 In those circumstances, the tax situation of a company which has its registered office in Germany and has a permanent establishment in another Member State 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 another Member State.

26 It must be held that the tax regime at issue in the main proceedings involves a restriction on the freedom of establishment.

Whether a justification exists

27 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 (see Case-C446/03 *Marks & Spencer* [2005] ECR I-10837, paragraph 35; *Cadbury Schweppes and Cadbury Schweppes Overseas*, paragraph 47; and *Test Claimants in the Thin Cap Group Litigation*, paragraph 64).

28 In that connection, the national court points out in particular that, in accordance with the provisions of the Convention, the income generated by the permanent establishment in Luxembourg is not taxed in the Member State of residence of the company to which it belongs.

29 In their observations to the Court, the German, Greek, French, Netherlands, Finnish, Swedish and United Kingdom Governments essentially submit that tax rules which, for the purposes of determining the tax base of a resident company, restrict the possibility for that company to deduct losses incurred by a permanent establishment belonging to it which is situated in another Member State can, as a rule, be justified.

30 Those Governments take the view that the justification for such rules in the light of Community law may be based, first, on the need to preserve the allocation of the power to impose taxes between the Member States concerned and, secondly, on the need to prevent the danger that losses may be taken into account twice.

31 As regards the first of these justifications, it should be noted that the preservation of the allocation of the power to impose taxes between Member States may make it necessary 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 (see *Marks & Spencer*, paragraph 45, and Case C-231/05 *Oy AA* [2007] ECR I?6373, paragraph 54).

32 To give companies the right to elect to have their losses taken into account in the Member State in which they are established or in another Member State would seriously undermine a balanced allocation of the power to impose taxes between the Member States, since the tax base would be increased in the first State, and reduced in the second, by the amount of the losses surrendered (see *Marks & Spencer*, paragraph 46, and *Oy AA*, paragraph 55).

33 With respect to the relevance of the first of these justifications in the light of the facts in the main proceedings, it should be pointed out that the Member State in which the registered office of the company to which the permanent establishment belongs is situated would, in the absence of a double taxation convention, have the right to tax the profits generated by such an entity. Consequently, the objective of preserving the allocation of the power to impose taxes between the two Member States concerned, which is reflected in the provisions of the Convention, is capable of justifying the tax regime at issue in the main proceedings, since it safeguards symmetry between the right to tax profits and the right to deduct losses.

34 In circumstances such as those of the main proceedings, to accept that the losses of a non-resident permanent establishment might be deducted from the taxable income of the principal company would result in allowing that company to choose freely the Member State in which those losses could be deducted (see, to that effect, *Oy AA*, paragraph 56).

35 As regards the second justification put forward in the observations submitted to the Court, which is based on the danger that losses might be taken into account twice, the Court has accepted that the Member States must be able to prevent such a danger (see *Marks & Spencer*, paragraph 47, and Case C-347/04 *Rewe Zentralfinanz* [2007] ECR I?2647, paragraph 47).

36 In this connection, it must be pointed out that, in circumstances such as those which underlie the main proceedings, there is clearly a danger that the same losses will be used twice (see *Marks & Spencer*, paragraph 48). It is possible that a company might deduct, in the Member State in which its seat is situated, losses incurred by a permanent establishment belonging to it and situated in another Member State and that, despite such offsetting, the same losses might be taken into account subsequently in the Member State in which the permanent establishment is situated, when that establishment generates profits, thereby preventing the Member State in which the principal company has its seat from taxing that profit.

37 Consequently, the two justifications put forward must each be considered as being capable

of justifying a restriction on the freedom of establishment arising from the tax treatment by the Member State in which the seat of a company is located of losses incurred by a permanent establishment belonging to that company and situated in another Member State.

38 The national court asks, however, whether the justifications set out in paragraphs 44 to 50 of the judgment in *Marks & Spencer*, which also include the need to prevent the risk of tax avoidance, must be understood as being cumulative or whether the existence of only one of those factors is sufficient for the tax regime at issue in the main proceedings to be treated, in principle, as being justified.

39 It must be pointed out in that regard that, in paragraph 51 of the judgment in *Marks & Spencer*, the Court held that the three justifications taken together, which underlay the legislation at issue in the main proceedings, pursued legitimate objectives compatible with the Treaty and thus constituted overriding reasons in the public interest

40 However, bearing in mind the wide variety of situations in which a Member State may put forward such reasons, it cannot be necessary for all the justifications referred to in paragraph 51 of the *Marks & Spencer* judgment to be present in order for national tax rules which restrict the freedom of establishment laid down in Article 43 EC to be capable, in principle, of being justified.

41 Thus, in the judgment in *Oy AA*, the Court acknowledged in particular that the national tax legislation at issue could, in principle, be justified on the basis of two of the three justifications referred to in paragraph 51 of the judgment in *Marks & Spencer*, namely the need to safeguard the allocation of the power to tax between the Member States and the need to prevent tax avoidance, taken together (see *Oy AA*, paragraph 60).

42 Likewise, the tax regime at issue in the main proceedings can, in principle, be justified in the light of two of the factors referred to in paragraph 51 of the judgment in *Marks & Spencer*, namely the need to safeguard the allocation of the power to tax between the Member States and the need to prevent the danger that the same losses will be taken into account twice.

43 It is also not in dispute that that regime is appropriate for ensuring the attainment of the objectives pursued by it.

44 That being so, it remains necessary to examine whether the tax regime at issue in the main proceedings goes beyond what is necessary to attain the objectives pursued (see *Marks & Spencer*, paragraph 53, and *Oy AA*, paragraph 61).

45 Lidl Belgium and the Commission of the European Communities have referred in particular to the possibility that the right of a principal company to deduct the losses incurred by a permanent establishment belonging to it could be made subject to the condition that the company incorporate in its future profits the subsequent profits of the permanent establishment, to the extent of the losses previously offset. In that context, they refer to the system which operated in the Federal Republic of Germany prior to 1999.

46 It should be pointed out that reference was made in paragraph 54 of the judgment in *Marks & Spencer* to the possibility of making the benefit of the tax advantage at issue subject to such a condition, together with the possibility of making the benefit of that advantage conditional upon the subsidiary established in a Member State other than that in which the principal company has its seat having taken full advantage of the possibilities available in its Member State of residence of having the losses taken into account.

47 In that regard, the Court held in paragraph 55 of the judgment in *Marks & Spencer* that a

measure which restricts the freedom of establishment goes beyond what is necessary to attain the objectives pursued where a non-resident subsidiary has exhausted the possibilities for having the losses incurred in the Member State where it is situated taken into account for the accounting period concerned and also for previous accounting periods and where there is no possibility for that subsidiary's losses to be taken into account in that State for future periods.

48 In paragraph 56 of that judgment, the Court also stated that where, in one Member State, the resident parent company demonstrates to the national tax authorities that those conditions are fulfilled, it is contrary to Article 43 EC to preclude the possibility for the parent company to deduct from its taxable profits in that Member State the losses incurred by its non-resident subsidiary.

49 As regards the main proceedings, it must be pointed out that Luxembourg tax legislation provides for the possibility of deducting a taxpayer's losses in future tax years for the purposes of calculating the tax base.

50 As was confirmed at the hearing before the Court, Lidl Belgium has in fact benefited from such an offsetting of the losses incurred by its permanent establishment in 1999 in a subsequent tax year, namely 2003, in which that entity generated profits.

51 Accordingly, Lidl Belgium has not shown that the conditions laid down in paragraph 55 of the judgment in *Marks & Spencer*, for establishing the situation in which a measure constituting a restriction on the freedom of establishment for the purposes of Article 43 EC goes beyond what is necessary to attain legitimate objectives recognised by Community law, were satisfied.

52 It must be added that the Court has recognised the legitimate interest which the Member States have in preventing conduct which is liable to undermine the right to exercise the powers of taxation which are vested in them. In this connection, where a double taxation convention has given the Member State in which the permanent establishment is situated the power to tax the profits of that establishment, to give the principal company the right to elect to have the losses of that permanent establishment taken into account in the Member State in which it has its seat or in another Member State would seriously undermine a balanced allocation of the power to impose taxes between the Member States concerned (see, to that effect, *Oy AA*, paragraph 55).

53 In the light of all of the above, the tax regime at issue in the main proceedings must be considered to be proportionate to the objectives pursued by it.

54 The answer to the question referred for a preliminary ruling must therefore be that Article 43 EC does not preclude a situation in which a company established in a Member State cannot deduct from its tax base losses relating to a permanent establishment belonging to it and situated in another Member State, to the extent that, by virtue of a double taxation convention, the income of that establishment is taxed in the latter Member State where those losses can be taken into account in the taxation of the income of that permanent establishment in future accounting periods.

Costs

55 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 43 EC does not preclude a situation in which a company established in a Member State cannot deduct from its tax base losses relating to a permanent establishment belonging to it and situated in another Member State, to the extent that, by virtue of a

double taxation convention, the income of that establishment is taxed in the latter Member State where those losses can be taken into account in the taxation of the income of that permanent establishment in future accounting periods.

[Signatures]

* Language of the case: German.