JUDGMENT OF THE COURT (Third Chamber)

15 February 2007 *

In Case C-345/04,

REFERENCE for a preliminary ruling under Article 234 EC from the Bundesfinanzhof (Germany), made by decision of 26 May 2004, received at the Court on 12 August 2004, in the proceedings

Centro Equestre da Lezíria Grande L^da^

v

Bundesamt für Finanzen,

THE COURT (Third Chamber),

composed of A. Rosas, President of the Chamber, A. Borg Barthet and U. Lõhmus (Rapporteur), Judges,

* Language of the case: German.

Advocate General: P. Léger,
Registrar: R. Grass,

after considering the observations submitted on behalf of:

— the German Government, by C.-D. Quassowski and A. Tiemann, acting as Agents,

— the Italian Government, by I.M. Braguglia, acting as Agent, and G. De Bellis, avvocato dello Stato,

— the Commission of the European Communities, by B. Eggers and R. Lyal, acting as Agents,

after hearing the Opinion of the Advocate General at the sitting on 22 June 2006,

gives the following

Judgment

1 This reference for a preliminary ruling concerns the interpretation of Article 59 of the EC Treaty (now, after amendment, Article 49 EC).

2 The reference has been made in proceedings between Centro Equestre da Lezíria Grande L^da ('CELG'), a company incorporated under Portuguese law, and the Bundesamt für Finanzen (Federal Finance Office) (Germany) ('the Bundesamt') concerning the latter's refusal to allow an application for repayment of corporation tax deducted at source on income received by CELG in Germany in its capacity as a taxpayer with restricted tax liability.

National legal context

3 Under Paragraph 2(1) of the Körperschaftsteuergesetz (German Law on Corporation Tax) (BGBl. 1991 I, p. 639) ('the KStG'), companies which are not established in Germany have restricted liability to tax and are liable to corporation tax in Germany only on their income received in that country.

4 In accordance with Paragraph 49(1) of the Einkommensteuergesetz (Law on Income Tax) (BGBl. 1997 I, p. 821), in the version applicable in 1997 ('the EStG 1997'), in conjunction with Paragraph 8(1) of the KStG and Article 17(2) of the Abkommen zwischen der Bundesrepublik Deutschland und der Portugiesischen Republik zur Vermeidung der Doppelbesteuerung auf dem Gebiet der Steuern vom Einkommen und vom Vermögen (Agreement between the Federal Republic of Germany and the Portuguese Republic for the prevention of double taxation in the field of income and wealth taxes) of 15 July 1980 (BGBl. 1982 II, p. 129), the income received by a company incorporated under Portuguese law in connection with artistic performances given in Germany is liable to corporation tax in that country.

5 Paragraph 50a(4)(1) of the EStG (BGBl. 1990 I, p. 1898), in the version applicable in 1996, was worded as follows:

'In the case of persons with restricted liability to tax, income tax shall be levied by means of retention at source on income from artistic, sporting or other performances organised in Germany or conducted in Germany, including income from other services provided in connection with those performances, irrespective of the person receiving the income ...'

6 However, the third clause of the fourth sentence of Paragraph 50(5) of the EStG 1997, applicable retroactively to the 1996 tax year, provides:

'[A] person subject to limited tax liability, whose income is subject to retention at source in accordance with Paragraph 50a(4)(1) or (2), [may] apply for full or partial repayment of the tax deducted and paid. Repayment shall be subject to the condition that the operating expenses or business costs that have a direct economic connection to that income are greater than half of that income.'

7 It is apparent from the documents in the case-file submitted to the Court that, unlike persons with restricted liability, those with unrestricted liability to tax in Germany may deduct from their taxable income in that Member State all of the costs relating to artistic or sporting performances which took place in that country.

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

8 CELG, the applicant in the main proceedings, is a capital company incorporated under Portuguese law which has its registered office and place of central management in Portugal. CELG has restricted liability to corporation tax in Germany, which is payable only on income received in that country. In 1996, it organised a tour in which equestrian presentations and lessons in dressage were given in 14 cities in various countries of the European Union, including 11 in Germany.

9 In 1997, CELG applied to the Bundesamt for repayment of the corporation tax that had been deducted at source on its income in Germany, namely a sum of DEM 71 758, on the basis of Paragraph 50(5) of the EStG 1997 and Paragraph 8(1) of the KStG.

10 To that end, CELG provided a certified Portuguese balance sheet which included a statement of the costs arising in relation to the whole of the 1996 tour. That statement set out communications, travel, accommodation, advertising and personnel costs, in addition to day-to-day expenses relating to the horses, water and electricity supply costs, costs relating to veterinary, medication and blacksmith services and to equipment for horses and riders, transporter and tax advice costs, together with writing-down costs for the horses. CELG subsequently claimed further costs relating to accountancy costs and the payment of licence fees. It sought to set 11/14ths of the total of those costs against the income it had received in Germany.

11 The Bundesamt refused to allow the repayment sought on the ground of the applicant's failure to supply the original invoices relating to the expenditure claimed.

12 The objection lodged by CELG against that decision was dismissed on the ground, inter alia, of the absence of a direct economic connection between certain of the costs declared and the income received in Germany.

13 CELG appealed against that decision rejecting its application to the Finanzgericht Köln (Cologne Finance Court) (Germany). That court dismissed the appeal on the grounds that, firstly, in respect of some of the costs claimed, there was no direct connection to the income that was taxable in Germany and, secondly, the costs claimed did not represent more than 50% of that income.

14 CELG thereupon appealed on a point of law ('Revision') to the Bundesfinanzhof (Federal Finance Court) (Germany) against the decision of the Finanzgericht Köln.

15 The Bundesfinanzhof observes that it is apparent from the findings of fact made by the Finanzgericht Köln that the costs incurred by CELG that have a direct economic connection to the income which that company received in Germany do not exceed 50% of that income. It notes, however, that CELG also claims overhead costs and that, although there is some confusion surrounding those overhead costs, as regards their nature, composition and amount, and as to whether there is additional income to be taken into account, it is apparent from those findings of fact that all of the costs incurred by CELG, including those overhead costs, are greater than half of the income.

16 However, the Bundesfinanzhof considers that, with regard to the computation of taxable income, the difference in treatment of a resident taxpayer, who is fully liable, and a non-resident taxpayer, who has only restricted liability, raises doubts as to whether the third clause of the fourth sentence of Paragraph 50(5) of the EStG 1997

is compatible with Community law, especially with regard to the freedom to provide services guaranteed by Article 59 of the EC Treaty. It refers in that connection to the judgment of the Court in Case C-234/01 *Gerritse* [2003] ECR I-5933.

17 In those circumstances, the Bundesfinanzhof decided to stay the proceedings and to refer the following question to the Court for a preliminary ruling:

'Is it contrary to Article 59 of the Treaty establishing the European Communities if a person with restricted tax liability in Germany who is a national of a Member State may claim repayment of tax deducted at source on his income in Germany only when the operating expenses that have a direct economic connection to that income are greater than half of that income?'

The question referred for a preliminary ruling

18 By its question, the national court wishes to know whether Article 59 of the EC Treaty precludes national legislation of a Member State, such as that at issue in the main proceedings, which, in the case of a taxpayer with restricted tax liability claiming repayment of corporation tax deducted at source, makes the deduction of operating expenses incurred in connection with activities which gave rise to the receipt of income in that State subject to the double condition that those expenses have a direct connection to that income in that State and that they are greater than half of that income.

19 As a preliminary point, it is to be noted 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 (see, to that effect, in particular, Case C-250/95 *Futura Participations and Singer* [1997] ECR I-2471, paragraph 19; Case C-294/97 *Eurowings Luftverkehr* [1999] ECR I-7447, paragraph 32; Case C-55/98 *Vestergaard* [1999] ECR I-7641, paragraph 15; Case C-141/99 *AMID* [2000] ECR I-11619, paragraph 19; and Case C-446/03 *Marks & Spencer* [2005] ECR I-10837, paragraph 29).

20 It is also to be noted that, according to the Court's case-law, Article 59 of the EC Treaty requires the abolition of any restriction on the freedom to provide services imposed on the ground that the person providing a service is established in a Member State other than that in which the service is provided (see, to that effect, in particular, Case 205/84 *Commission* v *Germany* [1986] ECR 3755, paragraph 25; Case C-180/89 *Commission* v *Italy* [1991] ECR I-709, paragraph 15; and Case C-290/04 *FKP Scorpio Konzertproduktionen* [2006] ECR I-9461, paragraph 31).

The existence of a direct economic connection

21 As is apparent from paragraph 18 above, the first condition for repayment of corporation tax deducted at source is that the operating expenses must have a direct economic connection to the income received in the State in which the activity is pursued.

22 It is clear from the Court's case-law that a tax system under which, for the purposes of calculating the basis of assessment for non-resident taxpayers in a particular Member State, only profits and losses arising from their activities in that State are taken into account is consistent with the principle of territoriality enshrined in international tax law and recognised by Community law (see, to that effect, *Futura Participations and Singer*, paragraphs 21 and 22).

23 With regard to operating expenses which have a direct connection to the activity pursued by a non-resident in a Member State and which generated taxable income in that country, such expenses should, in principle, be taken into account in that State if residents are taxed on their net income after deduction of those expenses. In its judgment in *Gerritse*, the Court found that, for the purposes of taking such costs into account, residents and non-residents were placed in a comparable situation. Since the Member State granted residents the possibility of deducting the costs in question, it could not, in principle, preclude their being taken into account for non-residents (see, to that effect, *Gerritse*, paragraph 27).

24 Thus, where powers of taxation are exercised by a State in the territory in which activity has generated taxable income, it must be possible for the costs directly connected to that activity to be taken into account in the taxation of non-residents. In that connection, Community law does not preclude a Member State from going further, by allowing costs that do not have such a connection to be taken into account (see, to that effect, *FKP Scorpio Konzertproduktionen*, paragraphs 50 to 52).

25 Operating expenses directly connected to the income received in the Member State in which the activity is pursued must be understood as being expenses which have a direct economic connection to the provision of services which gave rise to taxation in that State and which are therefore inextricably linked to those services, such as travel and accommodation costs. In that context, the place and time at which the costs were incurred are immaterial.

26 It is apparent from the documents before the Court that CELG, which is established in Portugal, received income in Germany from its artistic activities. CELG incurred a number of operating expenses in connection with its presentations, some of which were incurred beforehand in the organisation and planning of those presentations, and others in the course of giving those presentations, in respect of which it seeks a deduction in Germany. It is for the referring court, before which the dispute has

been brought and which must assume responsibility for the subsequent judicial decision, to determine in the main proceedings which of the operating expenses claimed by CELG are directly connected to the provision of services which gave rise to taxation in that State and are therefore inextricably linked to those services.

27 Article 59 of the EC Treaty does not therefore preclude national legislation from making repayment of corporation tax deducted at source on the income of a taxpayer with restricted tax liability subject to the condition that the operating expenses in respect of which that taxpayer seeks a deduction have a direct economic connection to the income received from activities pursued within the Member State concerned, provided that all of the costs that are inextricably linked to that activity are considered to have such a direct connection, irrespective of the place and time at which those costs were incurred.

The requirement that the costs be greater than half of the income

28 The second condition laid down in the legislation at issue in the main proceedings concerning repayment of tax deducted at source on a non-resident's income in Germany requires the operating expenses that have a direct economic connection to that income to be greater than half of that income.

29 Such a condition is liable to constitute a restriction on the freedom to provide services of a company wishing to pursue artistic, sporting or other activities in a Member State other than that in which it is established.

30 The consequence of that condition is that, where such a company seeks repayment of tax deducted at source, it cannot automatically obtain a deduction in respect of the costs directly connected to the economic activity concerned when the income from that activity is taxed.

31 It must therefore be held that, by making deduction of the operating expenses incurred by a taxpayer with restricted tax liability subject to that additional condition, the legislation in issue in the main proceedings constitutes, in principle, a restriction that is prohibited under Article 59 of the EC Treaty.

32 It is accordingly necessary to consider whether such a restriction can be justified.

33 The justification put forward by the German Government that the national legislation is intended to avoid the double counting of costs, that is to say, in both the Member State in which the registered office is situated and the State in which the services were provided and the income taxed, cannot be accepted.

34 Firstly, it should be noted that the Agreement between the Federal Republic of Germany and the Portuguese Republic for the prevention of double taxation in the field of income and wealth taxes of 15 July 1980 applies what is known as the offsetting method.

35 It follows that a Portuguese company is taxed in Portugal on all of its income, including income from activities pursued in Germany, where that income is also taxed. Double taxation is avoided through deduction in the first State of an amount

equal to the tax paid in the second State. Such a mechanism is appropriate for preventing the double counting of costs since, where it is applied by the first State, that State can check the operating expenses that have been taken into account in calculating the tax paid in the second State.

36 Moreover, Paragraph 50(5) of the EStG 1997 lays down a procedure under which the Ministry of Finance can provide the State of residence of a taxpayer with restricted tax liability with information concerning the application for repayment submitted by that taxpayer. That mechanism for cooperation between the competent national authorities also makes it possible to prevent any double counting of costs. Similarly, 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 (OJ 1977 L 336, p. 15) also contributes to the realisation of that objective by providing for the exchange of information between the tax authorities concerned.

37 A restriction on the freedom to provide services cannot therefore be justified where it arises from national legislation which makes repayment of tax deducted at source on the income received in the Member State concerned by a taxpayer with restricted tax liability subject to the condition that the operating expenses directly connected to that income are greater than half of that income. It must therefore be concluded that Article 59 of the EC Treaty precludes such legislation.

38 In the light of the foregoing, the answer to the question referred must be that Article 59 of the EC Treaty does not preclude national legislation such as that at issue in the main proceedings in so far as that legislation makes repayment of corporation tax deducted at source on the income of a taxpayer with restricted tax liability subject to the condition that the operating expenses in respect of which a deduction is claimed for that purpose by that taxpayer have a direct economic connection to the income received from activities pursued in the Member State concerned, on condition that

all the costs that are inextricably linked to that activity are considered to have such a direct connection, irrespective of the place and time at which those costs were incurred. By contrast, that article precludes such national legislation in so far as it makes repayment of that tax to that taxpayer subject to the condition that those same operating expenses exceed half of that income.

Costs

39 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 (Third Chamber) hereby rules:

Article 59 of the EC Treaty (now, after amendment, Article 49 EC) does not preclude national legislation such as that at issue in the main proceedings in so far as that legislation makes repayment of corporation tax deducted at source on the income of a taxpayer with restricted tax liability subject to the condition that the operating expenses in respect of which a deduction is claimed for that purpose by that taxpayer have a direct economic connection to the income received from activities pursued in the Member State concerned, on condition that all the costs that are inextricably linked to that activity are considered to have such a direct connection, irrespective of the place and time at which those costs were incurred. By contrast, that article precludes such national legislation in so far as it makes repayment of that tax to that taxpayer subject to the condition that those same operating expenses exceed half of that income.

[Signatures]