JUDGMENT OF THE COURT (Fourth Chamber)

28 February 2008 (*)

(Freedom of establishment – Taxation of companies – Monetary effects upon the repatriation of start-up capital granted by a company established in one Member State to its permanent establishment in another Member State)

In Case C-293/06,

REFERENCE for a preliminary ruling under Article 234 EC from the Finanzgericht Hamburg (Germany), made by decision of 8 June 2006, received at the Court on 3 July 2006, in the proceedings

Deutsche Shell GmbH

v

Finanzamt für Großunternehmen in Hamburg,

THE COURT (Fourth Chamber),

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

Advocate General: E. Sharpston,

Registrar: C. Strömholm, Administrator,

having regard to the written procedure and further to the hearing on 13 September 2007,

after considering the observations submitted on behalf of:

– Deutsche Shell GmbH, by A. Raupach and D. Pohl, Rechtsanwälte,

– the Finanzamt für Großunternehmen in Hamburg, by M. Fromm, acting as Agent,

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

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

– the Commission of the European Communities, by R. Lyal and G. Wilms, acting as Agents,

after hearing the Opinion of the Advocate General at the sitting on 8 November 2007,

gives the following

Judgment

1 This reference for a preliminary ruling concerns the interpretation of Article 52 of the EC Treaty (now, after amendment, Article 43 EC) and Article 58 of the EC Treaty (now, after amendment, Article 48 EC).

2 The reference was made in the course of proceedings between Deutsche Shell GmbH ('Deutsche Shell') and the Finanzamt für Großunternehmen in Hamburg ('the Finanzamt') concerning the tax treatment by the authorities in the Federal Republic of Germany of the monetary depreciation, upon repatriation, of start-up capital granted to Deutsche Shell's permanent establishment in another Member State.

Legal background

The Double Taxation Convention

3 Under Article 3 of the Double Taxation Convention concluded on 31 October 1925 between Germany and Italy (RGBl. 1925 II, p. 1146) ('the Convention'):

'(1) Non-personal taxes relating to income from commercial, industrial or other such activities may be levied only by the State within the territory of which the undertaking has its establishment …

…

(3) If the undertaking has permanent establishments in both States parties to this Convention, each of those States shall levy non-personal taxes in respect of the portion of income obtained through the activity of the establishments situated in its territory. …'

4 Article 11 of the Convention provides:

'Personal taxes relating to the total income of the taxable person shall be levied by each of the States parties to this Convention in accordance with the following provisions:

(1) Income

…

(c) arising from commercial, industrial or other similar activities, including income from the operation of marine transport facilities,

…

shall be subject to the same provisions as those determined for such income in the relevant articles.

…'

The German tax law applicable at the time of the facts in the main proceedings

5 Paragraph 1 of the Law on corporation tax (Körperschaftsteuergesetz) of 11 March 1991 (BGBl. 1991 I, p. 637) ('the KStG') provides:

'The following undertakings … which have their centre of administration or their registered office on

national territory have unlimited liability to tax:

(1) capital companies (companies limited by shares, limited liability companies);

…

(2) The unlimited obligation to pay corporation tax applies to all income.'

6 Under Paragraph 12 of the German Tax Code (Abgabenordnung):

'1. Any facilities or permanent place of business used for the activities of a company shall be deemed to be an establishment.

2. In particular, the following shall be regarded as establishments:

…

– branches.'

7 Paragraph 2a(3) of the Law on income tax (Einkommensteuergesetz) of 7 September 1990 (BGBl. 1990 I, p. 1898) ('the EStG') states as follows:

'Where under a double taxation convention the income of a tax payer with unlimited liability deriving from the industrial or commercial activities of a permanent establishment situated abroad is exempt … from income tax, a loss arising in connection with that income according to the provisions of Germany tax law shall, on the application of the taxpayer, be deducted when calculating the amount of the income to the extent that the taxpayer would be able offset or deduct *that loss* if the income were not exempt from tax and in so far as it exceeds positive income which is to be exempt under that convention deriving from industrial or commercial activities from other permanent establishments situated in the same foreign country. … To the extent that, in one of the subsequent tax years, the income deriving from the industrial or commercial activities of permanent establishments situated in that foreign State yields a positive amount overall, which is to be exempt in accordance with that convention, the amount deducted in accordance with the first and second sentences must, with respect to the relevant tax period, be taken into account once again for the calculation of the total amount of income.'

8 Paragraph 3c(1) of the EStG provides that:

'Where it has a direct economic link to tax-free income, expenditure may not be deducted as constituting operating expenditure or costs of acquiring, securing and maintaining income.'

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

9 Deutsche Shell, a capital company with its registered office and principal place of business in Germany, set up a permanent establishment in Italy in 1974 for the purpose of prospecting for and extracting natural gas and oil ('the permanent establishment'). Between 1974 and 1991 Deutsche Shell injected capital into that establishment in the form of start-up capital.

10 The profits repatriated to Germany from the permanent establishment were deducted from the 'start-up capital' in amounts calculated on the basis of the exchange rate for the German mark (DEM) and Italian

lira (ITL) on the day on which each payment was made by that establishment to Deutsche Shell.

11 The depreciation of the value of the ‘start-up’ capital granted to the permanent establishment was not taken into account in Italy for the taxation of its profits, as the basis of assessment was established in Italian lira.

12 In Germany Deutsche Shell has unlimited liability to tax on its worldwide income under Paragraph 1(1) of the KStG.

13 On 28 February 1992, Deutsche Shell transferred the assets of its permanent establishment to an Italian subsidiary, Sierra Gas Srl, a transaction for which it had to reveal its hidden reserves. The transfer of those assets put an end to the permanent establishment. On the same day Deutsche Shell transferred its shares in Sierra Gas Srl to Edison Gas SpA.

14 The amount in Italian lira obtained as a result of the above transactions was paid to Deutsche Shell on 17 July 1992 as reimbursement of the ‘start-up capital’.

15 Converted into Deutsche Marks at the exchange rate applicable on that date, ITL 1 000 for DEM 1.3372, the amount of ‘start-up capital’ thereby repaid, amounting to ITL 83 658 896 927, produced DEM 111 868 677.

16 Deutsche Shell regarded the negative difference of DEM 122 698 502 resulting from the comparison between the amount of DEM 111 868 677 and the ‘the start-up capital’ as a ‘currency loss’.

17 In the calculation of Deutsche Shell’s taxable income for the 1992 financial year the Finanzamt refused to take that loss into consideration in the corporation tax assessment notice it sent to Deutsche Shell on 19 September 1997.

18 On 2 October 1997 Deutsche Shell entered an objection to the tax assessment notice.

19 Having amended the tax assessment notice on 16 November 2001 and 5 August 2003 for reasons which are not relevant to the dispute, the Finanzamt dismissed the objection by decision of 7 August 2003. It took the view, in particular, that Deutsche Shell had not suffered real financial loss, that the depreciation in the value of the ‘start-up capital’ was merely part of the permanent establishment’s profits and that, even taking account of that depreciation, Deutsche Shell had achieved a positive result in the financial year concerned.

20 On 14 August 2003 Deutsche Shell brought an action before the Finanzgericht Hamburg against the dismissal of its objection by the Finanzamt.

21 Before the Finanzgericht Hamburg, Deutsche Shell submitted that the fact that it was unable to deduct the ‘currency loss’ for corporation tax purposes is incompatible with the freedom of establishment. In particular it argued that, in this case, it is placed in a less favourable situation than if the ‘start-up capital’ had been invested in a company established in Germany.

22 In those circumstances, the Finanzgericht, taking the view that the solution to the dispute before it depends on the interpretation of the provisions of the Treaty relating to the freedom of establishment, decided to stay its proceedings and to refer the following questions to the Court for a preliminary ruling:

‘1. Is it contrary to Article 52 in conjunction with Article 58 of the Treaty … for the Federal Republic of Germany, as the State of origin, to treat a currency loss of a German controlling company resulting from the repatriation of so-called start-up capital granted to an Italian establishment as being part of that establishment’s profits and to exclude that loss, on the basis of the exemption under Articles 3(1), 3(3) and 11.1(c) of the … Convention … from the basis of assessment for German tax, even though the currency loss cannot form part of the establishment’s profits to be assessed for purposes of taxation in Italy and thus cannot be taken into account in either the State of origin or in the State in which the establishment is situate?

2. If Question 1 is answered in the affirmative: is it contrary to Article 52, in conjunction with Article 58, of the Treaty … if the currency loss mentioned above is to be included in the basis for assessment of the German tax but may be deducted as operating expenditure only in so far as no tax-free profits are obtained from the Italian establishment?’

The action

The first question

23 By that question, the referring court asks essentially whether it is contrary to Article 52 in conjunction with Article 58 of the Treaty for a Member State to exclude from the basis of assessment for national tax a currency loss suffered by a company with a registered office in that State upon repatriation of start-up capital granted to its permanent establishment in another Member State.

24 As regards the factual situation giving rise to the dispute which led to the reference for a preliminary ruling, the Finanzamt and the German Government submit that, in this case, there has not been any real financial loss as a result of the exchange rate applicable at the time when the establishment was transferred and when the start-up capital was repatriated. They also state that Deutsche Shell and the permanent establishment formed a single economic entity and that, on the group balance sheet, there were always economic fluctuations related to changes in the exchange rate.

25 On that point, it must be observed that it is for the national court to determine whether the currency fluctuations alleged in the main proceedings led to a currency loss constituting a real economic loss affecting Deutsche Shell’s results for the financial year concerned.

26 It is, however, for the Court to answer the request for a preliminary ruling on the basis of the assessments made by the national court and to give it all the information necessary for it to resolve the dispute.

27 In those circumstances, the Court must determine whether, if there was a currency loss constituting a real economic loss, the decision taken by the Finanzamt to exclude such a loss from the calculation of that company’s basis of assessment for tax is liable to constitute an obstacle to the exercise of the freedom of establishment.

28 According to settled case-law, all measures which prohibit, impede or render less attractive the exercise of that freedom must be regarded as obstacles (see Case C-55/94 *Gebhard* [1995] ECR I-4165, paragraph 37, and Case C-442/02 *CaixaBank France* [2004] ECR I-8961, paragraph 11).

29 The Court has held in particular that such restrictive effects may arise specifically where, on account of a tax law, a company may be deterred from setting up subsidiary bodies such as permanent

establishments in other Member States and from carrying on its activities through such bodies (see Case C-446/03 *Marks & Spencer* [2005] ECR I-10837, paragraphs 32 and 33, and Case C-471/04 *Keller Holding* [2006] ECR I-2107, paragraph 35).

30 As the Advocate General observed in points 43 and 44 of her Opinion, the tax system concerned in the main proceedings increases the economic risks incurred by a company established in one Member State wishing to set up a body in another Member State where the currency used is different from that of the State of origin. In such a situation, not only does the principal establishment face the normal risks associated with setting up such a body, but it must also face an additional risk of a fiscal nature where it provides start-up capital for it.

31 As regards the case in the main proceedings, it must be observed that because it exercised its freedom of establishment Deutsche Shell suffered financial loss which was not taken into account either by the national tax authorities for the purposes of calculating the basis of assessment for corporation tax in Germany or with respect to the assessment for tax of its permanent establishment in Italy.

32 It must be held that the tax system at issue in the main proceedings constitutes an obstacle to the freedom of establishment.

33 As regards a possible justification for such an obstacle, the Finanzamt and the German Government argue in the alternative that it is based on grounds relating to the coherence of the tax rules and the allocation of tax competence between the two Member States concerned.

34 According to the first argument, taking account of the currency loss for the purposes of calculating Deutsche Shell's basis of assessment in Germany would lead to a non-coherent tax system, since any exchange rate gain obtained in a comparable situation would not be taken into account. Thus, the detriment resulting from the failure to take account of a currency loss is the corollary to the advantage resulting from the fact that an exchange rate gain would also be excluded from the basis of assessment.

35 According to the second argument, the Convention's allocation of tax powers between the Federal Republic of Germany and the Italian Republic is a legitimate objective. Member States are entitled to set down criteria for allocation of tax sovereignty, whether unilaterally or by means of bilateral agreements. By that convention the two Member States concerned decided to exempt permanent establishments situated on the territory of the co-Contracting State from income tax, which excludes the currency loss concerned from being taken into account.

36 Those two arguments cannot be accepted.

37 First, as far as concerns the argument based on the coherence of the tax system, it must be recalled that the Court has acknowledged that the need to preserve such coherence may justify a restriction on the exercise of the fundamental freedoms guaranteed by the Treaty (see Case C-204/90 *Bachmann* [1992] ECR I-249, paragraph 28; Case C-300/90 *Commission* v *Belgium* [1992] ECR I-305, paragraph 21; *Keller Holding*, paragraph 40; and Case C-379/05 *Amurta* [2007] ECR I-0000, paragraph 46).

38 However, for such an argument to succeed, the Court has held that a direct link must be established between the tax advantage concerned and the offsetting of that advantage by a particular tax levy (see, Case C-484/93 *Svensson and Gustavsson* [1995] ECR I-955, paragraph 18; Case C-436/00 *X and Y* [2002] ECR I-10829, paragraph 52; *Keller Holding*, paragraph 40, and Case C-386/04 *Centro di*

Musicologia Walter Stauffer [2006] ECR I-8203, paragraphs 54 to 56).

39 Furthermore, the direct nature of the link must be established, in light of the objective pursued by the tax rules concerned, in relation to the relevant tax payers by a strict correlation between the deductible element and the taxable element (see, to that effect, Case C-80/94 *Wielockx* [1995] ECR I-2493, paragraph 24).

40 As to the tax system at issue in the main proceedings, it must be stated that the comparison between the currency losses, on one hand, and currency gains, on the other, is irrelevant, since there is no direct relationship between those two elements for the purpose of the case-law set out in the two preceding paragraphs. The failure to take account of a currency loss in order to calculate Deutsche Shell's basis of assessment for the 1992 financial year is not offset by any tax advantage in the Member State where that company has its registered office or in the Member State where its permanent establishment is situated.

41 Second, as regards the argument based on the existence of the Convention, which has allocated the tax powers between the two Member States concerned, it is settled case-law that, in the absence of unifying or harmonising measures adopted by the Community, the Member States remain competent to determine the criteria for taxation of income and wealth with a view to eliminating double taxation by means, inter alia, of international agreements (see, Case C-290/04 *FKP Scorpio Konzertproduktionen* [2006] ECR I-9461, paragraph 54; Case C-374/04 *Test Claimants in Class IV of the ACT Group Litigation* [2006] ECR I-11673, paragraph 52; and Case C-231/05 *Oy AA* [2007] ECR I-0000, paragraph 52).

42 That competence also implies that a Member State cannot be required to take account, for the purposes of applying its tax law, of the negative results of a permanent establishment situated in another Member State which belongs to a company with a registered office in the first State solely because those negative results are not capable of being taken into account for tax purposes in the Member State where the permanent establishment is situated.

43 Freedom of establishment cannot be understood as meaning that a Member State is required to draw up its tax rules on the basis of those in another Member State in order to ensure, in all circumstances, taxation which removes any disparities arising from national tax rules, given that the decisions made by a company as to the establishment of commercial structures abroad may be to the company's advantage or not, according to circumstances (see, by analogy, Case C-403/03 *Schempp* [2005] ECR I-6421, paragraph 45).

44 As far as concerns the main proceedings, it must be noted that the tax disadvantage concerned relates to a specific operational factor which is capable of being taken into consideration only by the German tax authorities. Although it is true that any Member State which has concluded a double taxation convention must implement it by applying its own tax law and thereby calculate the income attributable to a permanent establishment, it is unacceptable for a Member State to exclude from the basis of assessment of the principal establishment currency losses which, by their nature, can never be suffered by the permanent establishment.

45 Therefore, the answer to the first question must be that it is contrary to Article 52 in conjunction with Article 58 of the Treaty for a Member State, when determining the national basis of assessment, to exclude a currency loss suffered by a company with a registered office in that State upon repatriation of

start-up capital granted to its permanent establishment in another Member State.

The second question

46 By this question the referring court asks, if the answer to the first question is answered in the affirmative, whether it is also contrary to Article 52 in conjunction with Article 58 of the Treaty if the currency loss concerned is deductible as operating expenditure of an undertaking with its registered office in a Member State only in so far as its permanent establishment in another Member State has not obtained any tax-free profits.

47 As is clear from the considerations set out in paragraphs 30 and 31 of this judgment, a limit on the setting-off of currency losses suffered by that permanent establishment according to its results is also liable to dissuade a company from pursuing its cross-border activities in the European Community through such a body and must, therefore, be regarded as an obstacle to the freedom of establishment.

48 As to any justification for that restriction, the Finanzamt and the German Government repeated their argument that the tax system is justified on the grounds of fiscal coherence and the allocation of tax powers between the two Member States concerned, their arguments in that connection being very similar to those mentioned in paragraphs 34 and 35 of this judgment.

49 The Finanzamt and the German Government also take the view that the tax system at issue in the main proceedings is designed to avoid losses being taken into account twice by excluding the deduction of expenditure made for the purposes of generating income abroad, the latter being exempt under the Convention. If the currency loss had to be taken into consideration as operating expenditure in Germany, Deutsche Shell would enjoy a double tax advantage, since the positive result of its permanent establishment is exempt from tax in Germany under the Convention and the currency loss cannot be taken into account for the basis of assessment in Italy. In other words, one single economic process is split artificially for the benefit of Deutsche Shell, since the income of the permanent establishment is exempt under the Convention and the currency loss is treated as operating expenditure of the undertaking, separate from the other operating expenditure incurred by it.

50 Since the two arguments put forward by the Finanzamt and the German Government essentially repeat their arguments with respect to the first question, it is sufficient to refer to paragraphs 37 to 44 of this judgment, from which it is clear that the exclusion of the currency loss cannot be justified by the grounds mentioned in paragraph 48 above.

51 As far as concerns the specific argument alleging that Deutsche Shell is likely to benefit from a double advantage from the currency loss, it must be observed that a Member State which has waived its tax powers by concluding a double taxation convention such as that applicable in the main proceedings cannot rely on the lack of tax powers with respect to the results of a permanent establishment which belongs to a company established in the territory of that State in order to justify the refusal to deduct expenditure incurred by that company which, by its nature, cannot be taken into account in the Member State where that establishment is situated.

52 It must be added that the fact that the permanent establishment made profits is irrelevant to Deutsche Shell’s right to deduct all of the currency loss resulting from the repatriation of the start-up capital granted to that establishment as company operating expenditure. If that were not the case, the currency loss could not be taken into account either by the Member State where the company’s registered office is situated or by the Member State in which the permanent establishment is based, since the accounting

records in that Member State drawn up in the national currency could not show the currency depreciation of the start-up capital.

53 The answer to the second question must therefore be that it is also contrary to Article 52 in conjunction with Article 58 of the Treaty for a Member State to allow a currency loss to be deducted as operating expenditure in respect of an undertaking with a registered office in a Member State only in so far as its permanent establishment in another Member State does not make any tax-free profits.

Costs

54 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:

1. **It is contrary to Article 52 of the EC Treaty (now, after amendment Article 43 EC) in conjunction with Article 58 of the EC Treaty (now Article 48 EC) for a Member State, when determining the national basis of assessment, to exclude a currency loss suffered by a company with a registered office in that State upon the repatriation of start-up capital granted to its permanent establishment in another Member State.**

2. **It is also contrary to Article 52 of the EC Treaty (now, after amendment, Article 43 EC) in conjunction with Article 58 of the EC Treaty (now Article 48 EC) for a Member State to allow a currency loss to be deducted as operating expenditure in respect of an undertaking with a registered office in a Member State only in so far as its permanent establishment in another Member State does not make any tax-free profits.**

[Signatures]

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* Language of the case: German.