JUDGMENT OF THE COURT (Third Chamber)

15 October 2009 (*)

(Free movement of capital – Immovable property – Income tax – Deductibility of rental losses from the taxable income of a person liable to tax – Application of the decreasing-balance method of depreciation to the costs of acquisition or construction – More favourable tax treatment confined to immovable property situated on the national territory)

In Case C-35/08,

REFERENCE for a preliminary ruling under Article 234 EC from the Finanzgericht Baden-Württemberg (Germany), made by decision of 22 January 2008, received at the Court on 31 January 2008, in the proceedings

Grundstücksgemeinschaft Busley and Cibrian Fernandez

v

Finanzamt Stuttgart-Körperschaften,

THE COURT (Third Chamber),

composed of J.N. Cunha Rodrigues, President of the Second Chamber, acting as President of the Third Chamber, P. Lindh, A. Rosas, U. Lõhmus (Rapporteur) and A. Ó Caoimh, Judges,

Advocate General: E. Sharpston,

Registrar: B. Fülöp, Administrator,

having regard to the written procedure and further to the hearing on 26 March 2009,

after considering the observations submitted on behalf of:

– Grundstücksgemeinschaft Busley and Cibrian Fernandez, by R. Busley, Rechtsanwalt,

– Finanzamt Stuttgart-Körperschaften, by H. Henzler, acting as Agent,

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

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

– the EFTA Surveillance Authority, by P. Bjørgan and L. Armati, acting as Agents,

having decided, after hearing the Advocate General, to proceed to judgment without an Opinion,

gives the following

Judgment

1 This reference for a preliminary ruling concerns the interpretation of Articles 18 EC and 56 EC.

2 The reference has been made in the course of proceedings between, on the one hand, Ms Busley and Mr Cibrian Fernandez, as joint heirs, and, on the other, Finanzamt Stuttgart-Körperschaften (Stuttgart Corporation Tax Office; 'the Finanzamt') concerning the Finanzamt's tax treatment, in respect of the period from 1997 to 2003, of income from a house in Spain which Ms Busley and Mr Cibrian Fernandez had inherited from their parents.

Legal context

Community legislation

3 Article 1(1) of Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty [Article repealed by the Treaty of Amsterdam] (OJ 1988 L 178, p. 5) states:

'Without prejudice to the following provisions, Member States shall abolish restrictions on movements of capital taking place between persons resident in Member States. To facilitate application of this Directive, capital movements shall be classified in accordance with the Nomenclature in Annex I.'

4 Among the capital movements listed in Annex I to Directive 88/361 are, under heading XI of the annex, personal capital movements, including inheritances and legacies.

National legislation

5 Paragraph 2a(1) of the Law on Income Tax (Einkommensteuergesetz), as applicable in the period from 1997 to 2003 ('the EStG'), provides that certain categories of negative income of foreign origin may be offset only against positive income of the same nature and from the same State as that negative income. In so far as the negative income cannot be offset in this way, it is to be deducted from the positive income of the same nature and originating in the same State that is received by the taxable person in subsequent periods of assessment. This deduction is allowed only in so far as the negative income could not be taken into account in earlier periods of assessment. The categories referred to include, at point 6(a) of the first sentence of Paragraph 2a(1), negative income from the letting or leasing of immovable property or property portfolios where such property is located in a State other than Germany.

6 Point 1 of the first sentence of Paragraph 7(4) of the EStG provides – in relation to deductions for depreciation, including full depreciation – for a write-down of 3% per annum of the cost of acquisition or construction of buildings forming part of the assets of an undertaking which are not used for residential purposes and in respect of which the building permit was applied for after 31 March 1985. Point 2 of the first sentence of Paragraph 7(4) sets out the annual depreciation rates for buildings which do not satisfy those conditions, including a write-down of 2% per annum of the cost of acquisition or construction of buildings completed after 31 December 1924.

7 By way of derogation from Article 7(4), it is possible, according to the first sentence of Article 7(5) of the EStG, to apply the decreasing-balance method of depreciation to buildings which are situated on the national territory and which were built by the taxable person or acquired by him before the end of the year of their completion. According to point 3(a) of the first sentence of Article 7(5), in the case of buildings – within the meaning of point 2 of the first sentence of Paragraph 7(4) of the EStG – built by the taxable person pursuant to an application for a building permit made after 28 February 1989 and before 1 January 1996, or acquired pursuant to a legally binding contract concluded after 28 February 1989 and before 1 January 1996, in so far as those buildings are used for residential purposes, the following amounts may be deducted from the cost of their acquisition or construction:

– in the year of completion and in each of the subsequent three years, 7%;

– in each of the subsequent six years, 5%;

– in each of the subsequent six years, 2%;

– in each of the subsequent 24 years, 1.25%.

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

8 The applicants in the main proceedings are siblings and Spanish nationals who have been resident in Germany since birth. In the period from 1997 to 2003, they received income from employment and were liable to tax in Germany on the whole of their income.

9 In 1990, the applicants' parents – also Spanish nationals – began to build a house in Spain, which was completed in 1993. The applicants' mother and father died in 1995 and 1996, respectively. On their father's death in November 1996, the applicants became proprietors of that house in their capacity as joint heirs ('Erbengemeinschaft'), but never lived there. The house was let from 1 January 2001 and sold in 2006.

10 In their tax returns submitted to the Finanzamt for the period from 1997 to 2003, the applicants requested (i) that the decreasing-balance method of depreciation provided for in Paragraph 7(5) of the EStG be applied to the house in question, and (ii) that the limited offsetting of losses provided for at point 6(a) of the first sentence of Paragraph 2a(1) of the EStG not be applied. The Finanzamt rejected those requests and applied the latter provision, together with the straight-line method of depreciation provided for in Paragraph 7(4) of the EStG, on the ground that the house in question was not situated in Germany.

11 The Finanzamt failed to rule on the objections to its refusal decision, which were raised within the appropriate time-limits. The applicants therefore brought an action before the referring court, claiming that the tax treatment of the income from their house in Spain infringes Articles 39 EC and 43 EC.

12 The referring court takes the view that the action initiated by the applicants cannot succeed under German law, since the house in question is not situated in Germany. However, it has doubts as to the compatibility with Article 56 EC of Paragraph 2a(1), first sentence, point 6(a), and Paragraph 7(5) of the EStG, and states that, if the Court of Justice finds that the EC Treaty precludes national provisions such as those just mentioned, the action must succeed.

13 In those circumstances, the Finanzgericht Baden-Württemberg decided to stay the proceedings and to refer the following questions to the Court of Justice:

'1. (a) Is it contrary to Article 56 EC for a natural person with unlimited tax liability in Germany to be unable to deduct losses from the letting or leasing of real estate located in another Member State [of the European Union] – in contrast to a loss from real estate on national territory – when calculating taxable income in Germany in the year in which the loss arises?

(b) Is it relevant whether the natural person made the real estate investment himself or does an infringement arise also where the natural person has become the owner of the real estate located in another Member State by way of inheritance?

2. Is it contrary to Article 56 EC for a natural person with unlimited tax liability in Germany to be able to apply only the normal method of depreciation in calculating income from the letting or

leasing of real estate located in another Member State [of the European Union], whilst being able to apply the higher decreasing-balance method of depreciation in the case of real estate on national territory?

3. If Questions 1 and 2 must be answered in the negative, are the national provisions at issue contrary to the freedom of movement laid down in Article 18 EC?'

14 At the hearing, the applicants in the main proceedings indicated to the Court that the Finanzamt had sent them a letter according to which their request for losses from the letting of their house in Spain was to be granted; that request is the subject of Question 1. However, as the referring court has not informed the Court of Justice of the withdrawal of that question, it is necessary to reply to it.

The questions referred for a preliminary ruling

Questions 1 and 2

15 By its first and second questions, which it is appropriate to consider together, the referring court asks, in essence, whether Article 56 EC precludes income-tax legislation of a Member State under which natural persons who are resident and liable to unlimited taxation in that State are entitled to have (i) losses from the letting or leasing of an immovable property deducted from the taxable amount in the year in which those losses arise, and (ii) the income from such property assessed on the basis of the application of the decreasing-balance method of depreciation, only if the property in question is situated on the territory of that Member State.

16 The referring court also wishes to establish whether Article 56 EC applies to a situation, such as that of the main proceedings, in which the persons concerned became the owners of the property by way of inheritance.

17 In that regard, the Court has consistently held that, in the absence of a definition in the Treaty of 'movement of capital' within the meaning of Article 56(1) EC, the nomenclature which constitutes Annex I to Directive 88/361 retains an indicative value, even though that directive was adopted on the basis of Articles 69 and 70(1) of the EEC Treaty (after amendment, Articles 69 and 70(1) of the EC Treaty, repealed by the Treaty of Amsterdam), it being understood that, according to the third paragraph of the introduction to that annex, the nomenclature which it contains is not exhaustive as regards the notion of 'movement of capital' (see, inter alia, Case C-386/04 *Centro di Musicologia Walter Stauffer* [2006] ECR I-8203, paragraph 22 and case-law cited, and Case C-67/08 *Block* [2009] ECR I-0000, paragraph 19).

18 The Court – noting, in particular, that inheritances consisting in the transfer to one or more persons of assets left by a deceased person come under heading XI of Annex I to Directive 88/361, entitled 'Personal capital movements' – has held that an inheritance, including one of immovable property, is a movement of capital for the purposes of Article 56 EC, except in cases where its constituent elements are confined within a single Member State (see, inter alia, Case C-513/03 *van Hilten-van der Heijden* [2006] ECR I-1957, paragraphs 40 to 42; Case C-43/07 *Arens-Sikken* [2008] ECR I-6887, paragraph 30; Case C-318/07 *Persche* [2009] ECR I-0000, paragraphs 26 and 27; and *Block*, paragraph 20).

19 Consequently, a situation in which natural persons residing in Germany and liable to unlimited taxation in that Member State inherit a house situated in Spain is one that is covered by Article 56 EC. It is therefore not necessary to consider whether Articles 39 EC and 43 EC apply, as argued by the applicants in the main proceedings.

20 With regard to the existence of restrictions on the movement of capital within the meaning of Article 56(1) EC, it should be noted that the measures prohibited by that provision include those which are likely to discourage non-residents from making investments in a Member State or to discourage that Member State's residents from doing so in other States (see Case C-370/05 *Festersen* [2007] ECR I-1129, paragraph 24; Case C-101/05 *A* [2007] ECR I-11531, paragraph 40; and Case C-377/07 *STEKO Industriemontage* [2009] ECR I-0000, paragraph 23).

21 It is not only national measures liable to prevent or limit the acquisition of an immovable property situated in another Member State which may be deemed to constitute such restrictions, but also those which are liable to discourage the retention of such a property (see, by way of analogy, *STEKO Industriemontage*, paragraph 24 and case-law cited).

22 It is apparent from the order for reference that, first, for the purposes of establishing the basis of assessment for income tax for a taxable person in Germany, the losses incurred in respect of the income from, inter alia, the letting of an immovable property situated in Germany can be taken into account in full in the year in which they arise. By contrast, under point 6(a) of the first sentence of Paragraph 2a(1) of the EStG, rental losses from an immovable property situated outside Germany are deductible only from subsequent positive income derived from letting that property.

23 Second, a person who is liable to tax in Germany can, under Paragraph 7(5) of the EStG, apply the decreasing-balance method of depreciation to an immovable property situated in Germany under the conditions set out in that provision. That method of depreciation is liable to result, in the early years, in a rental loss figure that is considerably higher and, in consequence, in a considerably lower tax burden for that person than those resulting from the straight-line method of depreciation provided for at point 2 of the first sentence of Paragraph 7(4) of the EStG, the latter being the only method of depreciation which may be applied to immovable property referred to in that provision if the property is situated outside Germany.

24 It is true that, so far as a taxable person residing in Germany is concerned, the negative income arising from an immovable property that is let in another Member State could ultimately be taken into account in Germany in so far as that property subsequently generates a positive income. Further, as the Finanzamt notes, the application of the decreasing-balance method of depreciation merely has the effect of deferring taxation by bringing forward depreciation.

25 Nevertheless, the fact remains that, even on the assumption that the taxable person in question retains such property for a sufficient period of time for all losses to be offset against subsequent positive income and for the acquisition or construction costs of that property to be written down in full, that person – unlike a taxable person resident in Germany who has invested in a property there – is not entitled to have those losses taken into account immediately or to an initially higher rate of depreciation, and is thus deprived of a cash-flow advantage, as has been pointed out by the Commission of the European Communities (see, by way of analogy, Case C-446/04 *Test Claimants in the FII Group Litigation* [2006] ECR I-11753, paragraphs 84 and 153, and Case C-347/04 *Rewe Zentralfinanz* [2007] ECR I-2647, paragraph 29).

26 It follows that the tax position of a natural person residing and liable to unlimited taxation in Germany who, like the applicants in the main proceedings, has an immovable property in another Member State, is less favourable than it would be if that property were situated in Germany.

27 That fiscal disadvantage is liable to discourage such a person both from investing in an immovable property that is situated in another Member State and from keeping any such property of which he is the proprietor. It follows that national measures such as those at issue in the main proceedings constitute

restrictions on the movement of capital which are prohibited, in principle, by Article 56 EC.

28 Nevertheless, it is necessary to consider whether those restrictions are justified – as the Finanzamt and the German Government maintain – and may thus be accepted on condition that they are appropriate for securing the attainment of the objective pursued and do not go beyond what is necessary in order to attain it (see, to that effect, Case C-451/05 *ELISA* [2007] ECR I-8251, paragraph 79; Case C-152/05 *Commission* v *Germany* [2008] ECR I-39, paragraph 26; and Case C-110/05 *Commission* v *Italy* [2009] ECR I-0000, paragraph 59).

29 In regard to point 6(a) of the first sentence of Paragraph 2a(1) of the EStG, the Finanzamt contends that that provision is consistent with the principle of territoriality, as the Court accepted in paragraph 22 of its judgment in Case C-250/95 *Futura Participations and Singer* [1997] ECR I-2471.

30 However, that principle, the purpose of which is to establish, in the application of Community law, the need to take into account the limits on the Member States' powers of taxation, does not preclude the taking into account by a person liable to unlimited taxation in a Member State of negative income from an immovable property situated in another State (see, by way of analogy, *Rewe Zentralfinanz*, paragraph 69). Consequently, that provision – by virtue of which the applicants in the main proceedings, who are liable to unlimited taxation in Germany, are unable to take into account losses from their house in Spain – cannot be considered as an implementation of the principle of territoriality.

31 In regard to Paragraph 7(5) of the EStG, both the Finanzamt and the German Government contend that the objective of point 3(a) of the first sentence of that subparagraph is to encourage the construction of rental property in order to satisfy the demand for such housing on the part of the German population. In their view, that objective is of a socio-political nature and constitutes an overriding reason in the public interest. The German Government went on to say, in response to questions put by the Court at the hearing, that only housing intended for rent can benefit from the decreasing-balance method of depreciation laid down by that provision, which was adopted in response to a widespread lack of such housing in Germany.

32 In that regard, even on the assumption that that objective is capable of justifying a restriction on the free movement of capital, it does not appear that such a national measure – which makes a clear distinction according to whether or not the housing intended for rent is situated in Germany – is appropriate for securing the attainment of that objective. Instead of targeting places where the shortage of such housing is particularly acute, point 3(a) of the first sentence of Paragraph 7(5) of the EStG disregards differing needs in different parts of Germany, as the applicants and the Commission pointed out at the hearing. In addition, the decreasing-balance method of depreciation can be applied to all categories of rental property, from the most basic to the most luxurious. That being the case, it cannot be assumed that private investors, who are motivated in particular by financial considerations, will meet the allegedly socio-political objective of that provision.

33 Accordingly, the answer to Questions 1 and 2 is that Article 56 EC precludes income-tax legislation of a Member State under which natural persons who are resident and liable to unlimited taxation are entitled to have (i) losses from the letting or leasing of an immovable property deducted from the taxable amount in the year in which those losses arise, and (ii) the income from such property assessed on the basis of the application of the decreasing-balance method of depreciation, only if the property in question is situated on the territory of that Member State.

Question 3

34 In view of the answer to the first and second questions, there is no need to reply to the third question.

Costs

35 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 56 EC precludes income-tax legislation of a Member State under which natural persons who are resident and liable to unlimited taxation are entitled to have (i) losses from the letting or leasing of an immovable property deducted from the taxable amount in the year in which those losses arise, and (ii) the income from such property assessed on the basis of the application of the decreasing-balance method of depreciation, only if the property in question is situated on the territory of that Member State.

[Signatures]

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* Language of the case: German.