OPINION OF ADVOCATE GENERAL MISCHO

delivered on 26 September 2002 [1]

1. The Finanzgericht (Finance Court) Münster (Germany) asks the Court to interpret Article 43 EC in a case in which, under German tax legislation, repayment of interest by a subsidiary established in Germany to its parent company whose corporate seat is in the Netherlands was reclassified as a covert distribution of profits.

I — The national legal framework

2. The Körperschaftsteuergesetz (Law on Corporation Tax, hereinafter the 'KStG'), in Paragraph 8a(1) (capital borrowed from shareholders) of the version in force from 1996 to 1998, provides as follows:

'Repayments in respect of loan capital which a company limited by shares subject to unlimited taxation has obtained from a shareholder not entitled to corporation tax credit which had a substantial holding in its share or nominal capital at any point in the financial year shall be regarded as a covert distribution of profits

...

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

...'

3. According to Paragraph 51 of the KStG:

'Exclusion of entitlement to tax credit and offsetting of corporation tax

1 — Original language: French.

If the shareholder is not liable to tax on receipts within the meaning of Heads 1 to 3 of Paragraph 20(1) or Head 2a of Paragraph 20(2) or if, under Head 1 or 2 of Paragraph 50(1), those receipts are not included in the taxable amount, there can be no tax credit or offsetting of corporation tax under Head 3 of Paragraph 36(2) of the Einkommensteuergesetz (Law on Income Tax).'

II — The facts

4. Lankhorst-Hohorst GmbH (hereinafter 'Lankhorst-Hohorst'), a limited liability company incorporated under German law, whose registered office is in Rheine, Germany, is engaged in the sale of boating equipment, goods for water sports, leisure and craft items, leisure and work clothing, furnishings, hardware and similar goods. In August 1996 it increased its share capital to DEM 2 000 000.

5. Lankhorst-Hohorst's sole shareholder is Lankhorst-Hohorst BV (hereinafter 'LH BV'), which has its registered office in the Netherlands, at Sneek. The sole shareholder in the latter is the, likewise Dutch, company Lankhorst Taselaar BV (hereinafter 'LT BV'), whose registered office is in Lelystad, the Netherlands.

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

7. The loan was intended as a substitute for capital. It was accompanied by a 'Patronatserklärung' (letter of support) under which LT BV would waive repayment of the loan if third party creditors made claims against Lankhorst-Horhorst.

8. The loan enabled Lankhorst-Hohorst to reduce its borrowing from AMRO-Bank Münster from DEM 3 702 453.59 to DEM 911 174.70 and therefore to reduce its interest burden.

9. For 1996, 1997 and 1998, the plaintiff's balance sheet showed a deficit not covered by equity capital. For 1998 this was DEM 1 503 165, the final balance being DEM 428 321.

10. In its corporation tax assessment notices for 1997 and 1998, of 28 June 1999, the tax authorities treated the interest paid to LT BV as a distribution of profits within the meaning of Paragraph 8a of the KStG and taxed it as such at the rate of 30% (under Head 3 of Paragraph 27(1) of the KStG).

11. According to the referring court, the exception in the second sentence of Paragraph 8a(1) of the KStG, for cases where the company in question could have obtained the loan capital from a third party under identical terms, could not apply. In view of the plaintiff's excessive indebtedness and its inability to provide security, it could not in fact have obtained a similar loan (granted without security and with a letter of support) from any third party.

12. By a decision of 14 February 2000, the tax authorities rejected the objection lodged by the plaintiff against the corporation tax assessment notices.

13. In support of its action before the referring court, Lankhorst-Hohorst states that the grant of the loan by the Netherlands shareholder was a rescue attempt by it and that the interest paid to that shareholder could not be classified as a covert distribution of profits. It argues, further, that Paragraph 8a of the KStG is discriminatory in view of the treatment it affords German shareholders who are entitled to the tax credit (unlike LH BV and LT BV which have their corporate seats in the Netherlands) and, consequently, contrary to Community law and to Article 43 EC in particular.

14. Lankhorst-Hohorst adds that it is necessary to have regard to the spirit and purpose of Paragraph 8a of the KStG, which is to prevent evasion of tax payable on the assets of companies limited by shares. In the present case, however, the loan was granted with the sole objective of minimising Lankhorst-Hohorst's costs and it enabled it to make significant savings on bank interest. The plaintiff points out in that regard, that, before modification of the bank loan, the interest was twice as high as that thereafter payable to LT BV. This is accordingly not a case in which a shareholder which is not entitled to deduct the tax paid by its subsidiaries is seeking to circumvent tax on true distributions of profits by authorising payments of interest to itself.

15. The Finanzamt Steinfurt (Steinfurt Tax Office) recognises that application of Paragraph 8a of the KStG could exacerbate the situation of firms and companies in difficulties. However, the clear wording of the provision, in its view, precludes any other interpretation in the light of its spirit and purpose. In that connection, the refer-

ring court likewise accepts that the wording of the paragraph does not suggest that, in addition to the factual requirements, there must also be evasion in order for the provision to apply.

16. The tax authorities take the view that Paragraph 8a of the KStG does not conflict with the Community principle of non-discrimination. Many countries have provisions with a similar objective, primarily in relation to abuse in specific cases, based on the proportion of equity capital to debt capital.

17. The Finanzamt states that the distinction made in Paragraph 8a of the KStG between those who are entitled to the tax credit and those who are not does not entail covert discrimination on the basis of nationality since Paragraph 51 in conjunction with Paragraph 5 of the KStG (on exemption from corporation tax) also excludes several categories of German taxable persons from entitlement to the tax credit.

18. Lastly, according to the Finanzamt, the principle of once-only taxation and the coherence of the German tax system justify applying Paragraph 8a of the KStG in the circumstances of the main proceedings.

19. The Finanzgericht Münster, citing the case-law of the Court of Justice, [2] expresses doubts as to whether Paragraph 8a of the KStG is compatible with Article 43 EC. It draws attention to the fact that, according to the case-law of this Court, a national of a Member State who has a holding in the capital of a company established in another Member State which gives him definite influence over the company's decisions and allows him to determine its activities is exercising his right of establishment. [3]

20. According to the referring court, there is infringement of the right to freedom of establishment where the different tax treatment of a subsidiary is based solely and without further objective justification on the fact that its sole shareholder, the parent company, has its corporate seat in a different Member State from that in which the subsidiary is established.

21. It observes, in that connection, that the rule in Paragraph 8a of the KStG is not linked directly to nationality but to whether the taxable person enjoys the tax credit. Legal persons not entitled to tax credit are essentially, under the KStG, German corporations which are exempt from corporation tax and foreign shareholders who do not have their holding in the capital of a German limited company in the form of German operating assets.

2 — See, in particular, Case 270/83 *Commission v France* [1986] ECR 273, Case C-311/97 *Royal Bank of Scotland* [1999] ECR I-2651, and Case C-294/97 *Eurowings Luftverkehr* [1999] ECR I-7447.

3 — Case C-251/98 *Baars* [2000] ECR I-2787.

22. Under those circumstances, a shareholder established in a different Member State is systematically subject to the rule in Paragraph 8a of the KStG whereas, of shareholders established in Germany, only a clearly defined category of taxable persons is exempt from corporation tax and is not, in consequence, entitled to the tax credit (that is to say, as a general rule, corporations governed by public law and those carrying on business in a specific field and performing tasks which should be encouraged). The latter category of corporations is not, it believes, in a position comparable to that of the plaintiff's parent company.

23. As regards the justification for applying Paragraph 8a of the KStG, the referring court points out that a party can only rely on considerations relating to the coherence of the tax system where there is a direct link between a fiscal advantage accorded, on the one hand, and taxation, on the other, in respect of the same taxable person. [4] There is, in its view, no such link in the present case.

III — The question referred for a preliminary ruling

24. In view of the foregoing, the Finanzgericht Münster, by order of 21 August 2000, stayed the proceedings and, under Article 234 EC, referred the following question to the Court of Justice for a preliminary ruling:

'Is the requirement of freedom of establishment for nationals of a Member State in the territory of another Member State laid down in Article 43 of the Treaty of 10 November 1997 establishing the European Community to be interpreted as precluding the national rule contained in Paragraph 8a of the German Körperschaftsteuergesetz?'

IV — Analysis

A — *Application of Article 43 EC in the present case*

25. It is necessary to examine, first of all, whether Article 43 EC applies to a case such as that now under consideration.

26. The plaintiff argues that the arrangements established by Head 2 of Paragraph 8a(1) of the KStG have the effect, essentially, of taxing subsidiaries differently according to whether their parent company is resident or not.

4 — Judgment of the Bundesfinanzhof of 30 December 1996, I B 61/96, Bunderssteuerblatt Part II 1997, p. 466, and *Eurowings Luftverkehr*, cited above.

27. The Court of Justice examined this issue at length in its judgment in *Metallgesellschaft and Others.* [5] The Court ruled as follows:

'37 It should be remembered that, according to settled case-law, although direct taxation falls within their competence, Member States must none the less exercise that competence consistently with Community law and avoid any discrimination on grounds of nationality (Case C-80/94 *Wielockx* [1995] ECR I-2493, paragraph 16, Case C-107/94 *Asscher* [1996] ECR I-3089, paragraph 36, Case C-311/97 *Royal Bank of Scotland* [1999] ECR I-2651, paragraph 19, and Case C-251/98 *Baars* [2000] ECR I-2787, paragraph 17).

...

41 Article 52 of the [EC Treaty (now, after amendment, Article 43 EC)] constitutes one of the fundamental provisions of Community law and has been directly applicable in the Member States since the end of the transitional period. Under that provision, freedom of establishment for nationals of one Member State within the territory of another Member State includes the right to take up and pursue activities as self-employed persons and to set up and manage undertakings under the conditions laid down for its own nationals by the law of the country where such establishment is effected. The abolition of restrictions on freedom of establishment also applies to restrictions on the setting up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of another Member State (Case 270/83 *Commission* v *France* [1986] ECR 273, paragraph 13, and *Royal Bank of Scotland*, paragraph 22).

42 Freedom of establishment thus defined includes, pursuant to Article 58 of the Treaty, the right of 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 Community, to pursue their activities in the Member State concerned through a branch or agency (Case C-264/96 *ICI* [1998] ECR I-4695, paragraph 20, and the case-law cited therein, and Case C-307/97 *Saint-Gobin ZN* [1999] ECR I-6161, paragraph 34). With regard to companies, it should be noted in this context that it is their corporate seat in the above sense that serves as the connecting factor with the legal system of a particular State, like nationality in the case of natural persons (*ICI* cited above, paragraph 20, and the case-law cited therein, and *Saint-Gobin ZN*, cited above, paragraph 36). Acceptance

5 — Joined Cases C-397/98 and C-410/98 [2001] ECR I-1727.

of the proposition that the Member State in which a company seeks to establish itself may freely apply to it a different treatment solely by reason of the fact that its corporate seat is situated in another Member State would thus deprive Article 52 of all meaning (*Commission* v *France*, cited above, paragraph 18).'

28. Specifically, it is therefore necessary to examine whether, as was the case in *Metallgesellschaft and Others*[6] for subsidiaries established in the United Kingdom, subsidiaries established in Germany are treated differently according to whether or not their parent company has its corporate seat in Germany.

The existence of a difference of treatment arising from the criterion used in Head 2 of Paragraph 8a(1) of the KStG

29. It emerges from reading the provision at issue, that is to say, Head 2 of Paragraph 8a(1) of the KStG, and from the commentary by the referring court, that it applies only to remuneration in respect of the loan capital which a company limited by shares subject to unlimited taxation, in the instant case, Lankhorst-Hohorst, has obtained '*from a shareholder not entitled to corporation tax credit*'.

6 — Paragraph 43.

30. The referring court states that those shareholders which are not entitled to the tax credit 'are essentially, under Article 51 of the KStG, German corporations which are exempt from corporation tax and foreign shareholders who do not have their holding in the capital of a German limited company in the form of German operating assets'.

31. According to the German Government, the fact that a significant number of German taxpayers are also excluded from the right to the tax credit proves that the criterion based on entitlement to the tax credit is not discriminatory.

32. This argument is not, however, compelling.

33. As the referring court, Lankhorst-Hohorst and the Commission rightly point out, the category of German undertakings which are not entitled to the tax credit is not an appropriate reference group for making a comparison with foreign taxpayers who are not, as a general rule, entitled to it. Undertakings in the first group are in fact intrinsically different from those which, like the plaintiff's parent company, are involved in commercial activities and operate with a view to a profit.

34. The undertakings comparable to the latter are, in contrast, resident parent companies which are involved in commercial activities. The comparison should therefore be with their treatment and that of their subsidiaries.

35. Already in the *Eurowings Luftverkehr* case, cited above, the German Government put forward an argument similar to the one it is now advancing in this case. It then asserted that the contested obligation on the lessee to make add-backs to the taxable amount for trade tax applied wherever the lessor was not liable to that trade tax, whether he was established in Germany or in another Member State. [7]

36. The Court of Justice, however, rejected that argument and stated as follows:

'35 In that regard, it is to be noted that in the main action the obligation to make the add-backs provided for in Paragraph 8(7) and Paragraph 12(2) of the [Gewerbesteuergesetz] is always applicable for German undertakings leasing goods from lessors established in another Member State, since the latter are never liable to pay the trade tax, whereas that obligation does not apply, in most cases, for German undertakings leasing goods from lessors established in Germany, the latter being generally liable to the tax, save in the rare instances mentioned in paragraphs 25 to 27 of this judgment.

36 The legislation at issue in the main case therefore establishes tax rules which differ, in the large majority of cases, according to whether the provider of the services is established in Germany or in another Member State.'

37. In the present case, likewise, the legislation at issue in the main proceedings amounts to the establishment of different tax rules according to whether the parent company, that is to say, the shareholder in the subsidiary, is established in Germany or in another Member State.

38. Head 2 of Article 8a(1) of the KStG, therefore, *invariably* applies, *ratione personae*, where a resident subsidiary such as Lankhorst-Hohorst has obtained loan capital from its non-resident parent company, whereas that is not true, under the same circumstances, for a resident subsidiary which has received loan capital from its resident parent company.

7 — Paragraph 25.

39. The German Government's reference at the hearing to a worked example submitted by it at the request of the Court does not refute that finding.

40. Basing itself on that example, the German Government asserted that a resident subsidiary which had obtained loan capital from a resident shareholder could likewise be subject to reclassification of the remuneration on that capital as a distribution of dividends.

41. It is appropriate, none the less, to reproduce the German Government's accompanying commentary to the worked example, which states as follows:

'It should be recalled that in the main action the lender, which, through a wholly-owned subsidiary, indirectly controls the borrower, provided a letter of support ("Patronatserklärung") for the loan, waiving repayment if third party creditors made claims against the borrower. The loan was therefore intended as a substitute for capital.

Wherever a shareholder declares that "he wishes to be taken into account for the purposes of his claim only after satisfaction of all the undertaking's creditors and, — until the crisis is averted — not before but only at the same time as calls by its co-shareholders for repayment of their contributions" (see judgment of the Bundesgerichtshof of 8 January 2001, Part II, ZR 88/89 DStR p. 175, 176), the loan commitment should not be entered as a liability in the trading and tax accounts of the lender in the form of loan capital. The loan is "converted" into equity capital. If, in the main action, the terms of the letter of support are to be interpreted in that way, then the tax treatment, in a situation with no foreign element, is as follows (as shown by an example): [worked example]'.

42. That commentary shows that reclassification, in the worked example, is based fundamentally on there being a 'Patronatserklärung' (the Bundesgerichtshof uses the expression 'Rangrücktrittserklärung'). However, such a prerequisite for reclassification is quite different from the requirements set out in Head 2 of Paragraph 8a(1) of the KStG, which attaches no importance to the presence of a 'Patronatserklärung'.

43. Even though, in the present case, Lankhorst-Hohorst did obtain such a letter from its parent company, the fact remains that it was subject to reclassification not by reason of that 'Patronatserklärung', but on the basis of Head 2 of Paragraph 8a(1) of the KStG.

44. Since subsidiaries in the same position as Lankhorst-Hohorst, but whose parent company is resident, cannot be subject to such a reclassification — the provision in issue not applying to them — the German Government cannot claim that Lankhorst-Hohorst received the same treatment as those subsidiaries.

45. Having therefore established that there is a difference of treatment, it is necessary now to examine its consequences. It seems to me beyond doubt that the difference operates solely to the detriment of a resident subsidiary which has obtained loan capital from a non-resident parent company.

46. I note that it follows from the order for reference that, as the result of application of Head 2 of Paragraph 8a(1) of the KStG, the interest paid by Lankhorst-Hohorst was taxed as a covert payment of dividends at a rate of 30%.

47. It is apparent, conversely, from information provided at the hearing by counsel for Lankhorst-Hohorst and not disputed by the German Government, that, where there is no reclassification, earnings derived from loan interest are taxed in the hands of the resident parent company which receives that interest.

48. The result is therefore that, if the requirements for the application of Head 2 of Paragraph 8a(1) of the KStG are satisfied, a subsidiary which has obtained loan capital from a non-resident parent company is subject to taxation in respect of the interest in question, whereas a subsidiary which has obtained loan capital from a resident parent company is not.

49. Furthermore, according to the explanation given by the referring court, where a shareholder is entitled to the tax credit, the tax on the distribution of dividends is set against its personal income tax. That is not so where the shareholder is not entitled to a tax credit, which, as has already been seen, is invariably the position with shareholders resident abroad.

50. The German Government, moreover, confirmed at the hearing that, by operation of the tax credit, the amount of tax payable at the level of the Federal budget is zero for a group consisting of a resident parent company and resident subsidiary. Conversely, if the parent company is non-resident, the tax paid by the subsidiary on the distribution of dividends represents, according to the German Government, a final charge.

51. That difference of treatment linked to entitlement to the tax credit, even if one takes the view that it affects the position of the non-resident parent company (in the present case, LT BV) rather than that of the

subsidiary (Lankhorst-Hohorst), is likewise liable to infringe Article 43 EC.

52. As the referring court rightly points out with reference to the *Baars* judgment, a national of a Member State who has a holding in the capital of a company established in another Member State which gives him definite influence over the company's decisions is exercising his right of establishment. That is indisputably true of LT BV which holds 100% of the capital in Lankhorst-Hohorst.

53. Lastly, unlike the German Government, I am of the view that freedom of financing is in fact more restricted as regards the options for financing the resident subsidiary of a non-resident parent company than as regards the options for financing the resident subsidiary of a resident parent company.

54. The German Government maintains, on that point, that the loan to which Head 2 of Paragraph 8a(1) of the KStG relates none the less remains loan capital and is not reclassified as equity capital.

55. Be that as it may, the fact remains that such financing is treated, from a fiscal point of view, as a capital contribution.

56. The effect of Head 2 of Paragraph 8a(1) of the KStG is, consequently, such that, if the requirements for application of that provision are satisfied, a non-resident parent company can no longer usefully opt to finance its subsidiary by using loan capital. Its freedom of financing is therefore, in practice, more limited than that of a resident parent company.

Existence of an overriding requirement of general interest justifying the difference of treatment

57. Since it seems to me to have been established that the second sentence of Paragraph 8a(1) of the KStG does give rise to a difference of treatment, whether to the detriment of the resident subsidiary of a non-resident parent company or of the non-resident parent company itself, it is necessary to examine whether there is an overriding requirement of general interest which justifies that difference. [8]

58. The referring court describes the purpose of that provision as being 'to prevent shareholders not entitled to the tax credit

8 — See, in particular, Case C-250/95 *Futura Participations and Singer* [1997] ECR I-2471, paragraph 26, and Case C-35/98 *Verkooijen* [2000] ECR I-4071, paragraph 43.

from circumventing the once-only imposition of corporation tax on distributed profits intended by the law by endowing a company limited by shares with loan capital rather than equity capital'.

59. More particularly, the German, United Kingdom and Danish Governments and the Commission submit that the provision in question is a rule adopted to combat under-capitalisation ('thin capitalisation').

60. The Danish Government states that such rules were adopted in a series of countries, both inside and outside the European Union, as economies become increasingly internationalised and as the need to prevent tax avoidance makes itself increasingly felt.

61. That Government submits that by their very nature the rules on thin capitalisation only relate, in fact, to cross-border transactions. In the situation of a transaction between two fully-taxable domestic companies, the tax-deductible interest expense of one company will be equal to the earnings from taxable interest of the other and the net result will be fiscally neutral for the group. It is only where the transactions take place between companies having their registered offices in different countries that the tax debt can be transferred from one country to another.

62. Accordingly, in the view of the Danish Government, in the event of an injection of funds by a parent company into a subsidiary in the form of a capital loan instead of a capital contribution, the profits of the subsidiary are transferred to the parent company in the form of deductible interest instead of non-deductible dividends. If the two companies are in different countries, the tax debt can in that way be transferred from one country to another at the will of the parties to the transaction.

63. The governments which lodged observations are thus in agreement that, since the rules on thin capitalisation are intended to prevent the arbitrary transfer of the tax debt from one country to another and to ensure that the tax is charged in the place where the profit was actually made, there can be no finding of discrimination between the tax arrangements applicable to cross-border operations and those applicable to domestic operations.

64. Those same governments refer to Article 9 of the model convention drawn up by the Organisation for Economic Cooperation and Development (hereinafter the 'OECD model convention') for the

prevention of double taxation.[9] That article provides for the add-back of profits for tax purposes, where transactions take place between associated enterprises (parent company and subsidiaries or companies under common control) on other than market terms (the 'arm's length principle').

65. According to the German Government, Head 2 of Paragraph 8a(1) of the KStG is the embodiment of that principle, primarily in the field of returns which are independent of the profits and turnover of the company.

66. The Commission also believes that the difference of treatment deriving from Paragraph 8a of the KStG can be justified by its purpose, which is to ensure the taxation of profits in Germany in the case of undertakings not entitled to a tax credit and accordingly the correct allocation of the right to tax and the related tax revenue. In other terms, it is a matter of preventing thin capitalisation abuses, by preventing the covert distribution of dividends in the form of interest, which reduces the annual results of the subsidiary and thereby diminishes the tax revenue of the relevant Member State.

67. However, according to the Commission, the rule in Paragraph 8a of the KStG must also comply with the principle of proportionality. The Commission points out that the rule prescribes the proportion of loan capital to equity capital and makes an exception where loan capital could also have been made available by an unconnected third party on the same conditions.

68. However, the Commission refers to the risk of double taxation in this case: the German undertaking is subject to German corporation tax on profits distributed whilst the foreign shareholder still has to declare in the Netherlands, as earnings, amounts it has received in the form of interest. In the view of the Commission, a Member State which classifies an interest payment as a covert distribution of profits must also ensure that there is liaison on the matter with the State in which the parent company is registered, so that a cor-

9 — According to Article 9 of the OECD model convention,
'1. Where
(a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
(b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,
and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.
2. Where a Contracting State includes in the profits of an enterprise of that State — and taxes accordingly — profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of that first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.'

responding adjustment can be made. In the absence of any such adjustment, the risk of double taxation cannot be ruled out.

69. The Commission submits that, in the present case, Article 9(2) of the OECD model convention may afford the outline of a solution. In its view, the model convention, whilst consistent with the principle of proportionality, ensures the correct sharing of the right to tax, on the one hand, and the tax revenue of the Member States involved, on the other.

70. What should one make of those arguments?

71. The question is what is the true purpose of rules on thin capitalisation, of which, according to the interveners, Head 2 of Paragraph 8a(1) of the KStG is one.

72. Is the purpose to protect, in general terms, the financial soundness of a subsidiary by compelling it to have sufficient equity capital?

73. That is what the German Government is suggesting in asserting that 'a shareholder wishing to rescue its company must inject supplementary equity capital. Loan capital would, moreover, be economically damaging to the undertaking at such a juncture. Any new interest-bearing loan creates new costs for the company, which even further exacerbate its financial situation'.

74. It seems clear to me, however, that protecting the financial soundness of subsidiaries is not the true purpose of the tax legislation at issue in the main proceedings. Were that the purpose, the thin capitalisation rule would also have to apply to the subsidiaries of a resident parent company, which is not the case.

75. The real purpose of the thin capitalisation rule in the form of Head 2 of Paragraph 8a(1) of the KStG is therefore to prevent the Federal Republic of Germany from losing a portion of its revenue in the form of taxation, owing to the use by the taxpayer (or its shareholder) of a financing mechanism which is not in itself prohibited.

76. That purpose is confirmed not only by the explanations of the referring court and those expounded by the interveners, but also by academic commentary on Head 2

of Paragraph 8a(1) of the KStG and on the thin capitalisation rules in general. [10]

77. It does not seem to me, however, that such an objective can amount, in the context of Article 43 EC, to an overriding requirement of general interest justifying a difference of treatment.

78. It is settled case-law that 'diminution of tax revenue cannot be regarded as a matter of overriding general interest which may be relied upon in order to justify a measure which is, in principle, contrary to a fundamental freedom'. [11]

79. The fact that the thin capitalisation rules supposedly comply with Article 9 of the OECD model convention does not, in my view, alter the position.

80. Indeed, assuming that such compliance were established, [12] it must still be pointed out that the fact that the rules are consistent with the provisions of the OECD model convention does not also mean that they comply with Article 43 EC. Neither the provisions nor the objectives of the OECD model convention, on the one hand, or of the EC Treaty, on the other, are in fact the same.

81. Admittedly, nothing precludes an interpretation the EC Treaty, so far as possible, in accordance with an OECD model convention. [13] However, I take the view that it is not possible to do so in the present case, always assuming that a provision such as Head 2 of Paragraph 8a(1) of the KStG does comply with Article 9 of the OECD model convention.

82. Article 43 EC does not, admittedly, prevent Member States from taxing profits generated in their territories and in that sense does not affect their jurisdiction in relation to fiscal policy. However, it establishes a restriction on that freedom in that it cannot be exercised in a way which gives rise to discrimination. That is an inescapable fact, irrespective of anything which the provisions of the OECD model convention may permit.

10 — See, in particular, Menck, in Blümich, *Einkommensteuer-Körperschaftsteuer-Gewerbesteuer. Kommentar,* KStG § 8a(2): 'Bei Steuerausländern soll die Einmalerfassung des in Deutschland erwirtschafteten Gewinns gewährleistet bleiben und damit die deutsche Besteurerungshoheit gegenüber dem Ausland zur Geltung gebracht werden', and Sommerhalder, R.A., 'Approaches to Thin Capitalisation', *European Taxation*, 1996, p. 82, 82: 'The expression "thin capitalisation" is commonly used to describe a situation where the proportion of debt to equity exceeds certain limits and thin capitalisation legislation is a tool used by tax authorities to prevent what they regard as a leakage of tax revenues as a consequence of the way in which a corporation is financed'. Sometimes, the mere title is eloquent. See, for example, Hey, F.E.F., 'To Stop Revenue Loss, Germany Reconsiders Thin Capitalisation Rules', *Journal of International Taxation*, 1993, p. 264.

11 — *Metallgesellschaft and Others*, paragraph 59 of the judgment. See also the judgments in *ICI*, paragraph 28, and *Verkooijen*, paragraph 59.

12 — See, however, for a negative view as regards compliance with certain provisions of the OECD model convention, Knobbe-Keuk, B., 'Wieder einmal ein Entwurf zu § 8a KStG — Wiederauflage einer Regelung zur Gesellschaftfremdfinanzierung im Standortssicherungsgesetz', *Der Betreib*, 1993, pp. 60, 63 to 65, and Meilicke, W., 'Zur Vereinbarkeit des § 8a mit dem gemeinschaftrechlichen Diskriminierungsverbot', *Steuerrecht*, 2000, pp. 748, 748.

13 — See, for example, Case C-336/96 *Gilly* [1998] ECR I-2793, paragraph 31.

83. The German and the United Kingdom Governments also consider that Head 2 of Paragraph 8a(1) of the KStG is justified by the overriding requirement of general interest consisting of the need to ensure the coherence of the applicable tax systems. [14]

84. In that connection, however, it must be pointed out, as did the referring court, that the Court of Justice has stated that such an overriding requirement exists only if the fiscal coherence is 'established in relation to one and the same person by a strict correlation' between a tax advantage and unfavourable tax treatment. [15]

85. The German Government does not indicate what tax advantage offsets the unfavourable tax treatment of the subsidiary of a non-resident parent company to which Head 2 of Paragraph 8a(1) of the KStG applies.

86. I therefore do not find that a rule such as the provision at issue here is justified by a need to preserve the coherence of the applicable tax systems.

87. The German Government also submits that the rule in Paragraph 8a of the KStG is justified as a measure intended to combat abuse.

88. It refers, in that regard, to paragraph 24 of the *Centros* judgment, [16] which states that '... according to the case-law of the Court a Member State is entitled to take measures designed to prevent certain of its nationals from attempting, under cover of the rights created by the Treaty, improperly to circumvent their national legislation or to prevent individuals from improperly or fraudulently taking advantage of provisions of Community law...'.

89. It is necessary, however, to point out in that connection that the tax legislation at issue in the main proceedings covers, generally, any situation in which the parent company is, for any reason whatsoever, established outside the Federal Republic of Germany. Such a finding was sufficient for the Court to reject the argument based on the risk of tax avoidance put forward by the United Kingdom Government in the *ICI* case. [17]

90. Thus, according to the Court of Justice, '... the establishment of a company outside the United Kingdom does not, of itself,

14 — Case C-204/90 *Bachmann* [1992] ECR I-249, paragraph 21, Case C-300/90 *Commission* v *Belgium* [1992] ECR I-305, paragraph 14, *Baars*, paragraph 37, and *Metallgesellschaft and Others*, paragraph 67.

15 — *Wielockx*, paragraph 24. See also Case C-484/93 *Svensson and Gustavsson* [1995] ECR I-3955, paragraph 18, *Eurowings Luftverkehr*, paragraph 42, and *Baars*, paragraph 40.

16 — Case C-212/97 [1999] ECR I-1459.

17 — Paragraph 26 of the judgment.

necessarily entail tax avoidance, since that company will in any event be subject to the tax legislation of the State of establishment'.[18]

91. The fact that the provision at issue 'does not have the specific purpose of preventing wholly artificial arrangements, set up to circumvent [the] tax legislation'[19] of the Federal Republic of Germany is, moreover, confirmed by the facts of the present case.

92. The provision at issue here applies to a situation in which, according to the findings of the referring court itself, there was no abuse, since the loan was made 'to prevent financial disaster on the part of the plaintiff and to reduce the burden of loan interest arising from banking commitments'.

93. Additionally, as pointed out above, a resident parent company, as a result of the tax credit, can set the tax on the distribution of dividends against its personal income tax, which a non-resident parent company is not able to do.

94. That gives rise, in economic terms, to a higher tax charge for the group of a non-resident parent company than for the group of a resident parent company, which cannot be ascribed merely to a concern to combat tax avoidance.[20]

95. I therefore take the view that the need to combat tax avoidance does not, in the present case, constitute an overriding requirement of general interest justifying the difference of treatment deriving from a rule such as the provision at issue.

96. Lastly, it is necessary to examine the argument put forward by the United Kingdom Government in *Futura Participations and Singer*, in which the Court of Justice held, in paragraph 31, that '... the effectiveness of fiscal supervision constitutes an overriding requirement of general interest capable of justifying a restriction on the exercise of fundamental freedoms guaranteed by the Treaty...'.

97. It suffices, however, in that regard, to note that the present case does not concern tax supervision in the true sense, as distinct from the situation in the *Futura Participations and Singer* case, which related to the requirement that the taxpayer keep

18 — Ibid. See, also, *Metallgesellschaft*, paragraph 57.

19 — *ICI*, paragraph 26 of the judgment.

20 — Similar considerations led the Court of Justice to reject the argument based on the risk of tax avoidance in *Metallgesellschaft and Others*, paragraph 58 of the judgment.

accounts in compliance with certain rules in the Member State in which tax is to be charged so that the tax authorities of that Member State can ascertain the amount of taxable income.

98. Having regard to the foregoing, I am therefore of the view that there is no overriding requirement of general interest justifying the difference of treatment deriving from a rule such as the provision at issue. Such a rule is therefore, in my view, contrary to Article 43 EC.

99. It falls to the German authorities to determine whether the provision in issue should be replaced by, for example, a provision extending to subsidiaries with a resident parent company the rules on the reclassification of interest as dividends. [21] In the meantime, however, the provision at issue cannot be applied. [22]

B — *Application of Directive 90/435/EEC*

100. In response to a question from the Court of Justice, the parties gave their views on the relevance which Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States [23] may have for resolution of the dispute in the main proceedings.

101. The Danish Government states that, were this an instance of an overt distribution of dividends, that distribution would, by virtue of Article 5(1) of Directive 90/435, be exempt from withholding tax. Accordingly, a covert distribution should receive the same treatment.

102. In contrast, the German Government, the United Kingdom Government and the Commission consider that Article 5(1) of Directive 90/435 does not relate to the tax at issue. In their view, that tax is not a withholding tax but normal taxation of the profits of the subsidiary, in the form of corporation tax.

103. The Commission further adds that to hold in any other way would have the effect of totally prohibiting any so-called 'thin capitalisation' rules. The Commission believes that such rules are a useful tool in achieving fair taxation.

21 — See Scheffler, W., 'Der Einfluss der Steuerreform auf die Finanzierung von deutschen Kapitalgesellschaften', *Steuerrecht*, 2000, pp. 2441, 2447.

22 — See, in particular, Case 48/71 *Commission* v *Italy* [1972] ECR 529, paragraphs 6 to 8, and Case 106/77 *Simmenthal* [1978] ECR 629, paragraph 17.

23 — OJ 1990 L 225, p. 6.

104. Neither of those two arguments that Directive 90/435 should not apply is, however, convincing.

105. The fact that, under German tax legislation, the present case concerns a tax on the profits of the subsidiary, in the form of corporation tax, does not also mean that Directive 90/435 does not apply.

106. As the Court of Justice held in *Athinaïki Zythopoiia*, [24]

'26 [I]n order to determine whether the taxation of distributed profits pursuant to the Greek legislation at issue in the main proceedings falls within the scope of Article 5(1) of the directive, it is necessary, first, to refer to the wording of that provision. The term "withholding tax" contained in it is not limited to certain specific types of national taxation (see Case C-375/98 *Epson Europe* [2000] ECR I-4243, paragraph 22).

27 Second, it is settled case-law that the nature of a tax, duty or charge must be determined by the Court, under Community law, according to the objective characteristics by which it is levied, *irrespective of its classification under national law* (see, in particular, Joined Cases C-197/94 and C-252/94 *Bautiaa and Société française maritime* [1996] ECR I-505, paragraph 39)'. [25]

107. By the same token, in my view the fact that classification of the tax at issue as a withholding tax within the meaning of Article 5(1) of Directive 90/435 would, as the Commission claims, have the effect of completely prohibiting any 'thin capitalisation' rules does not preclude such a classification.

108. Article 5(1) of Directive 90/435 does not provide for any exceptions allowing non-application of that provision in order to protect the 'thin capitalisation' rules.

109. I endorse the Danish view that Article 5(1) of Directive 90/435 does apply to the tax at issue.

24 — Case C-294/99 [2001] ECR I-6797.

25 — My emphasis.

110. It seems to me that the considerations which led the Court of Justice, in the *Athinaïki Zythopoiia* case, cited above, to classify the tax at issue in the main proceedings as a withholding tax are present in this case also.

111. Specifically, the Court of Justice held that '... the chargeable event for the taxation at issue in the main proceedings... is the payment of dividends. In addition, the amount of tax is directly related to the size of the distribution'. [26]

112. Further, according to the Court, '... [t]he taxation relates to income which is taxed only in the event of a distribution of dividends and up to the limit of the dividends paid. That is shown by the fact (*inter alia*) that, as the applicant in the main proceedings and the Commission have pointed out, the increase in the basic taxable amount generated, in accordance with Article 106(2) and (3) of the Income Tax Code, by the distribution of profits cannot be offset by the subsidiary using negative income from previous tax years, contrary to the fiscal principle enabling losses to be carried forward which is nevertheless laid down in Greek law'. [27]

113. In the instant case, the event giving rise to the taxation is likewise the payment of (covert) dividends and the amount of taxation is directly related to the size of the distribution.

114. Moreover, as can be inferred from the order for reference, Lankhorst-Hohorst was not able to offset, against losses from previous years, the increase in its basic taxable amount resulting from the application of Head 2 of Paragraph 8a(1) of the KStG.

115. The Commission further suggests that Head 2 of Paragraph 8a(1) of the KStG could fall within the exception in Article 1(2) of Directive 90/435, according to which that directive '... shall not preclude the application of domestic or agreement-based provisions required for the prevention of fraud or abuse'.

116. That argument cannot, however, be accepted.

117. If, as indicated above, Head 2 of Paragraph 8a(1) of the KStG and the difference of treatment deriving from that provision are not justified by an overriding requirement of general interest consisting of the need to combat tax avoidance, it necessarily follows that the same provision

26 — *Athinaïki Zythopoiia*, cited above, paragraph 28.
27 — *Athinaïki Zythopoiia*, cited above, paragraph 29.

cannot be found to be justified by the need to combat fraud and abuse, as permitted by Article 1(2) of Directive 90/435.

118. The inevitable conclusion is, therefore, in my view, that Directive 90/435 does not apply to the tax at issue.

119. That said, I take the view that, even if the Federal Republic of Germany exempted from withholding tax the covert distribution of profits within the meaning of Head 2 of Paragraph 8a(1) of the KStG, that would not necessarily remove the discrimination for the purposes of Article 43 EC.

120. Where, for example, the subsidiary of a non-resident parent company is not authorised to deduct, from its total taxable amount, interest paid to its parent company as an expense under the same conditions as the subsidiary of a resident parent company, there could still be discrimination even if there were no withholding of tax.

V — Conclusion

121. Having regard to the foregoing considerations, I propose that the Court should reply to the Finanzgericht Münster as follows:

Article 43 EC precludes application of a rule such as that contained in Head 2 of Paragraph 8a(1) of the Körperschaftsteuergesetz (Law on Corporation Tax).