

European Court Questions the Taxation of Foreign Foundations in Germany

According to German tax law, tax exemption granted to public benefit organisations does not apply to public benefit organisations, which have their registered office and/or governance structure outside Germany. This principle of German law could be in conflict with the EC Treaty. The European Court of Justice (ECJ)¹ is currently review the matter. The Court's Advocate General, Christine Stix-Hackl published her opinion on the case on December 15th 2005². It outlines a potential conflict of the German rules with the free movement of capital according to article 56 EC-Treaty.

Background

In July 2004, the German Federal Tax Court³ requested a preliminary ruling from the ECJ regarding the compatibility with the EC-Treaty⁴ of the German tax scheme for foreign public benefit foundations in comparison to the tax regime of Germany-based public benefit foundations. The case concerns a public benefit foundation based in Italy, Centro di Musicologia Walter Stauffer, with income from German real estate assets, which was taxed by the German tax authorities. The Italian foundation went to court to question the tax authority's decision up to the German Federal Tax Court, which in turn called for a preliminary ruling from the ECJ. The Italian foundation pursues public benefit purposes in line with the German general tax code⁵ and if it were a Germany based organisation it would be tax-exempt according to the corporate income tax code⁶. However, this tax exemption for public benefit organisations does not apply to foreign public benefit organisations, which have their office and/or governance structure outside Germany⁷.

Summary of the Opinion of Christine Stix-Hackl

The opinion of the Advocate General of the ECJ addresses the following four issues:

1. Are basic freedoms of the European Treaty applicable to public benefit foundations?

The Advocate General states that public benefit foundations as well as national tax rules governing them could in principle be covered by basic freedoms of the EC-Treaty. The legislative competence in the field of direct taxation lies with the Member States. However they must ensure that these national laws do not discriminate individuals or legal entities on grounds of their nationality. As regards the applicability of the EC-Treaty provisions to public benefit foundations, the crucial question would be the economic nature of the activity of the organisation and not the public benefit nature of the organisation.

2. Which basic freedom is applicable?

The Advocate General examines further which basic freedom granted under the EC Treaty would apply to the case.

-Freedom of establishment (article 43 EC-Treaty)?

The opinion reviews whether the letting of real estate would fall under the freedom of establishment. It does not regard the freedom of establishment applicable for the case in question. The letting of German real estate would require a local permanent establishment. The Italian foundation has no offices in Germany and the administrator of the real estate does not act on behalf of the foundation.

¹ C-386/04

² The opinion of the Advocate General can be downloaded at <http://curia.eu.int/jurisp/cgi-bin/form.pl?lang=en&Submit=Submit&alldocs=alldocs&docj=docj&docop=docop&docor=docor&docjo=docjo&numaff=C-386%2F04&datefs=&datefe=&nomusuel=&domaine=&mots=&resmax=100>

³ *Bundesfinanzhof* (BFH)

⁴ Case No. I R 94/02, decision of 14 July 2004

⁵ *Abgabenordnung*

⁶ According to Article 5, section 1 no. 9 corporate income tax code (*Körperschaftsteuergesetz*)

⁷ According to Article 5, section 2 Nr. 3 and Article 2 Nr. 2 corporate tax law

-Free movement of capital (article 56 EC-Treaty)?

Instead, the Advocate General regards the free movement of capital applicable with regard to the real estate activity. The Italian based foundation bought real estate in Germany and the purchase of real estate is qualified as a movement of capital⁸. In addition, the opinion states that a public benefit purpose foundation falls under the free movement of capital.

3. Is there a breach of EC Treaty provisions concerning the free movement of capital?

The opinion reviews whether the taxation by Germany of the Italian foundation with rental income in Germany would represent a restriction to the free movement of capital provided for in article 56 EC-Treaty. Article 58.1a of the EC-Treaty allows Member States to distinguish between taxpayers who are not in the same situation with regard to their places of residence or the place where the capital is invested. However this rule has been interpreted in a narrow way to avoid arbitrary discrimination, and discrimination between persons who are in fact in the same position. The German tax exemption does not apply to foreign public benefit organisations, which have their office and/or governance structure outside Germany⁹. Only those foreign foundations, which set up an office in Germany or move their governance structure to Germany would benefit from tax breaks. The opinion concludes that the German tax rule treats organisations with a residence in another Member State less advantageously than local based organisations¹⁰.

4. Arbitrary discrimination - justification of current German tax law?

Then the opinion analyses if the German-based and foreign foundations would be in a comparable situation, a differential treatment between those organisations could be justified on the grounds of public good. The opinion leaves it to the Member State level to set requirements for a tax-exempt status for public benefit organisations, which could very well require that activities must benefit the national level¹¹. The German Higher Court of Finance has however interpreted German tax law in a way that does not require German tax-exempt foundations to be active in Germany only¹². The opinion therefore regards a foreign-based public benefit foundation, which pursues its activities outside Germany as being in a comparable situation to an organisation based in Germany.

The opinion does not see any ground of justification applicable for the different tax treatment of resident and non-resident public benefit foundations. The German government argues that tax exemptions were provided because these organisations would relieve the German State from some of its duties. This did not convince the Advocate General, who stated that this could only be the case if the tax-exempt status would require that the organisation would benefit Germany. This is not the case as the German tax code only distinguishes according to the residence of the organisation. Potential abuse, fiscal fraud or reduced incomes for the State were neither regarded as valid justifications¹³.

What is the impact for the foundation sector?

The decision of the European Court could open the door for the review of other national foundation tax laws and their compatibility with EC-Treaty provisions. As mentioned above, according to the Advocate General, a different tax treatment of resident and non-resident organisations would be in line with the EC Treaty, if national tax laws would require that exempt organisations work for the “national public good”. It is hoped that the debate around this case does not encourage Member States to step backwards and limit the public good to regional or national borders. This raises the need for foundations to have the adequate legal framework, and the specific tools, including the European Foundations Statute, to work across borders and benefit from cross-border donations and other income.

The Way Forward

The ruling of the European Court of Justice is awaited in due course. The EFC secretariat will keep its members informed of developments on the matter. EFC members are invited to contact the EFC secretariat at eu@efc.be for further information.

⁸ See point 41 of the opinion

⁹ According to Article 5, section 2 Nr. 3 and Article 2 Nr. 2 corporate tax law

¹⁰ See point 79 of the opinion

¹¹ See point 94 of the opinion

¹² See however the recent more restrictive approach of the German Ministry of Finance and the EFC briefing on this approach, which can be downloaded under

<http://www.efc.be/content/alert.asp?ContentID=969>

¹³ See point 115 – 117 of the opinion