Reports of Cases

OPINION OF ADVOCATE GENERAL
MENGOZZI
delivered on 12 July 2012 [1]

Case C-168/11

Manfred Beker,
Christa Beker
v
Finanzamt Heilbronn

(Reference for a preliminary ruling from the Bundesfinanzhof, Germany)

(Free movement of capital — Prevention of double taxation by means of set-off system — Set-off limited to the national tax which would have been owed on income earned abroad — Calculation method)

1. It is well known that direct taxation is one of the most complex and sensitive areas covered by the Court's case-law. In the absence of significant harmonisation at Union level the Court's judgments are essentially based on the Treaties and precedents in case-law, starting from the basic principle that the relevant power remains with the Member States but that they are required to exercise it having due regard to Union law. Furthermore, the problems to be addressed are often very technical in nature, which, to difficulties of legal interpretation, adds those relating to the functioning of the calculation mechanisms and the application of the taxes which are considered in each case.

2. The present case, which concerns the methods for calculating the maximum tax credit granted by a Member State, in order to limit juridical double taxation, to taxpayers who have earned income abroad, brings together all the difficulties set out above.

I – Legislative framework

3. The only provision of Union law relevant to the present case is Article 63 TFEU, formerly Article 56 EC, relating to the free movement of capital. As we know, paragraph 1 of Article 63 provides that 'all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited'.

1 — Original language: Italian.

4. The situation at issue in the main proceedings concerns a case of juridical double taxation,[2] in which two taxpayers resident in Germany, who are also subject to unlimited tax liability in that State, earned income, from the distribution of dividends, in other States, both other Member States and third countries.

5. To cover such situations, Germany concluded a number of double taxation conventions. In our case, in its order the referring court states as relevant, in particular, those concluded with the Netherlands, Switzerland, France, Luxembourg, Japan and the United States. All those agreements provide that, in order to reduce juridical double taxation, the so-called 'set-off system' is to be applied to income received abroad and taxed there by withholding at source. This mechanism is commonly used in similar circumstances and has also been established as one of two possible systems[3] for avoiding double taxation in the OECD Model Convention with Respect to Taxes on Income and on Capital ('the OECD model').[4]

6. I will set out below details of how that system functions and how it was put into practice by the German legislature. In general, however, the set-off system functions as follows. The tax base is calculated in the State of residence, taking account of all the taxpayer's income, including that earned abroad. The tax owed, under national law, is then calculated in relation to that entire tax base. This *theoretical tax* is then reduced by subtracting from it the tax paid abroad (set-off). In practice, the taxpayer is granted a tax credit to compensate for the fact that taxes on income earned abroad have already been paid there. Under Article 23B of the OECD model, the amount of the tax credit is, in principle, to be equal to the amount of the tax paid abroad, but it cannot exceed the tax on foreign income which would have been owed under the tax law of the State of residence. In particular, Article 23B of the OECD model provides, in the relevant part:

'1. Where a resident of a Contracting State derives income … which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall allow:

(a) as a deduction from the tax on the income of that resident, an amount equal to the income tax paid in that other State;

…

… such deduction … shall not, however, exceed that part of the … tax, as computed before the deduction is given, which is attributable … to the income … which may be taxed in that other State.'

2 — As we know, there is *juridical double taxation* where the same person is taxed twice in respect of the same source of revenue which maintains its legal classification: in the present case, for example, the dividends received by the applicants in the main proceedings are taxed – always as dividends and always as belonging to the same person – first in the State in which they are distributed and then in the State in which the applicants are resident. On the other hand, there is *economic double taxation* where the same source of revenue is taxed twice by two different persons, for example in the case of revenue taxed first by corporation tax and then, after the distribution thereof in the form of a dividend, by a tax on dividends or the income of natural persons.

3 — The other possible system provided for in the OECD Model Convention is the exemption mechanism. Under that mechanism, revenue taxed abroad is not taxed in the taxpayer's country of residence. However, there are numerous possible variations on the two basic systems set out above.

4 — Naturally, that model convention is not binding, but it does constitute the reference used most frequently to draw up bilateral conventions in that field. The most recent version of the OECD model dates from 2010 and can be found on the organisation's website, www.oecd.org.

7. The OECD model does not lay down precise methods for calculating the maximum set-off. Germany specifically implemented the mechanism in question by Article 34c(1) of the Einkommensteuergesetz (also the 'EStG'), the law on income tax. In the version applicable to the facts of the case, that is to say in 2007, the rule in question provided, in particular, as follows:

'In the case of taxpayers with unlimited tax liability whose foreign income is liable to tax corresponding to German income tax in the State in which the income originates, the tax paid abroad ... shall be offset against German income tax due in respect of income from that State. The German tax on foreign income shall be calculated by apportioning the German tax on the taxable income, including foreign income, in the proportion that that foreign income bears to total income …'.

8. I will set out in detail the specific functioning of the system below when discussing the question referred.

II – Facts, main proceedings and the question referred

9. Mr and Mrs Beker, the applicants in the main proceedings, are resident in Germany where they are subject to unlimited tax liability. They earn most of their income in Germany but also received some dividends in various foreign States, both EU Member States and third countries.

10. All the dividends received abroad were taxed in the respective States of origin by withholding at source. It is clear from the information provided by the referring court that double taxation conventions exist between Germany and all the other States from which the dividends received by Mr and Mrs Beker originate. Those conventions provide that, in a case such as this, the taxes levied abroad on dividends are to be taken into consideration in Germany to reduce double taxation by using the set-off method. As can be seen above, that involves granting a tax credit for taxes paid abroad which, however, is not greater than the tax which would have been owed on the foreign income if it had been taxed in Germany where the taxpayers are resident.

11. According to the German method for calculating the maximum set-off, set out in the abovementioned Article 34c of the EStG, the following formula must be used in that respect:

Maximum amount deductible = Total theoretical German tax x (foreign income/total income)

12. The total theoretical German tax stated in the formula is calculated on the total taxable income, including both income received in Germany and income received abroad. Therefore, it is tax which the taxpayer would have had to have paid if all the income had been earned in Germany. To determine the income to be taxed, the total income is taken, regardless of where it is received, and all the allowances permitted under German law are applied.

13. The objective of the second part of the formula is to determine which 'part' of the total income is foreign. Consequently, the multiplication must make it possible to identify which part of the total theoretical German tax can be linked to the foreign income in question. That part constitutes the maximum set-off which can be granted in respect of taxes which have already been paid abroad.

14. As can be seen, what is used in the denominator of the fraction is not the income to be taxed (which is, however, used to calculate the first element of the formula, that is to say the total theoretical German tax), but rather the total income to which I referred in point 12. Naturally, the total income is greater than the income to be taxed since the latter is obtained, as we have seen, *starting from the total income and deducting a number of items from it*. In the case of Mr and Mrs Beker, in particular, the deductions which were taken into consideration in obtaining the income to be taxed on the basis of the total income concerned certain insurance premiums, donations for purposes protected by law and church tax.

15. An obvious consequence of the use, in the denominator of the fraction contained in the formula, of total income instead of the taxable income is to reduce the maximum set-off which can be granted to the taxpayer.

16. In the present case, Mr and Mrs Beker paid abroad, by withholding at source, over EUR 2 850 in tax. However, applying the formula reproduced above, the German tax authorities granted a maximum set-off limit of EUR 1 282. If taxable income rather than total income were used as the denominator of the fraction, the tax credit could, as far as can be understood, be around EUR 1 650.

17. The case which has arisen as a result of the appeal against the measure by the tax authorities has reached the referring court which, uncertain of the compatibility of national law with Union law, has stayed proceedings and referred the following question to the Court for a preliminary ruling:

'Does Article 56 EC preclude a rule in a Member State by which – in accordance with treaties concluded in order to avoid double taxation – in the case of taxpayers with unlimited tax liability whose foreign income is liable to tax corresponding to national (German) income tax in the State in which the income originates, the foreign tax is offset against national (German) income tax levied on income from that State in such a way that the national (German) income tax resulting from assessment of the income to be taxed – including foreign income – is apportioned in the proportion that that foreign income bears to total income – and hence without taking into account special expenditure or extraordinary costs as costs relating to personal lifestyle and personal and family circumstances?'

III – Analysis

A – *Preliminary remarks*

1. Scope of the questions raised by the applicants before the national court

18. In their written observations, the applicants in the main proceedings pointed out that their application in the main proceedings was intended, essentially, to have almost all the German tax set off against the tax paid abroad by withholding at source. Thus, by focussing the actual question on the lack of consideration, for calculation purposes, of certain allowances, the referring court took a more restricted view than the applicants.

19. That fact, even if it were true, is irrelevant for the purposes of the present case. In the preliminary ruling procedure there is established between the national court and the Court of Justice real cooperation in which, in principle, the national court alone can determine the facts, the applicable law and the questions which need to be answered in order to resolve the dispute.[5] In this context, the Court challenges the analysis of the national courts only in exceptional circumstances. In particular, the Court cannot answer questions which are hypothetical or in any event unconnected with the matter to be resolved.[6]

5 — See, for example, recently, Case C-62/06 *ZF Zefeser* [2007] ECR I-11995, paragraph 14, and Case C-247/08 *Gaz de France - Berliner Investissement* [2009] ECR I-9225, paragraph 19.

6 — The case-law in that regard is abundant and settled. See, for example, recently, Case C-11/07 *Eckelkamp and Others* [2008] ECR I-6845, paragraph 28, and Case C-41/11 *Inter-Environnement Wallonie and Terre wallonne* [2012] ECR, paragraph 35.

20. In the present case there are no grounds for concluding that the national court has drawn up a question which is hypothetical or irrelevant for the purposes of resolving the dispute. On the contrary, the relevance of the Court's response to the decision in the main action appears to be evident. It should also be added that in the final part of its order for reference the national court states explicitly that the application which the applicants have brought before it is limited to correcting the denominator of the fraction used in the formula by including therein the allowances which I referred to above.

21. In those circumstances, I consider that the question referred is not only admissible but also requires no clarification and/or rephrasing. [7]

2. The relevant provisions

22. The referring court phrased its question with reference only to Article 56 EC, now Article 63 TFEU, concerning the free movement of capital. In the proceedings certain doubts were raised as to whether it was correct to rely on that provision and some of those who submitted observations asked whether other fundamental freedoms should have been relied on, and in particular, possibly, the freedom of establishment.

23. All those who considered the relevance of Article 63 TFEU came to the conclusion that that it is the correct provision, and I can only agree. It is common ground that the shareholdings from which Mr and Mrs Beker derived dividends concern only the 'float', that is to say shares which do not form part of a controlling interest in the companies which issued them. The Court has consistently held that the provisions on the freedom of establishment can be relied on, in the case of a shareholding, only if such holding makes it possible to exercise definite influence over the company's decisions. If that is not so – and it certainly is not in the present case –, use must be made instead of the rules on the free movement of capital. [8]

24. It should also be observed, with regard to Article 63 TFEU, that it does not apply solely to movements of capital between Member States but also to those between Member States and third countries. Therefore, the fact some of the shares held by Mr and Mrs Beker are in States outside the Union is irrelevant in assessing whether there is a restriction prohibited under Article 63 TFEU. [9]

B – *The question referred*

1. Preliminary observations

25. Certain key principles which the Court's case-law on direct taxation has laid down should be recalled at this point.

7 — According to settled case-law, the rephrasing of questions referred for a preliminary ruling, concerns cases where an answer to the questions, as phrased by the referring court, would not allow that court to resolve the case before it. See, for example, Joined Cases C-329/06 and C-343/06 *Wiedemann and Funk* [2008] ECR I-4635, paragraph 45, and Case C-138/10 *DP grup* [2011] ECR I-8369, paragraph 29.

8 — Case C-436/00 *X and Y* [2002] ECR I-10829, paragraphs 66 to 68, and Case C-446/04 *Test Claimants in the FII Group Litigation* [2006] ECR I-11753, paragraphs 37 and 38. See also Case C-251/98 *Baars* [2000] ECR I-2787, paragraphs 21 and 22, and Case C-196/04 *Cadbury Schweppes and Cadbury Schweppes Overseas* [2006] ECR I-7995, paragraph 31.

9 — That fact could, at most, be relevant in assessing the possible justifications for the restriction since it is not always as easy to exchange tax information with third countries as it is among Member States (See Case C-101/05 *A* [2007] ECR I-11531, paragraphs 60 to 63, and Case C-318/07 *Persche* [2009] ECR I-359, paragraph 70). However, this matter was not even raised in the present case.

26. Firstly, it should be observed that this matter per se does not fall within the competences of the Union. However, the competences of the Member States must be *exercised* consistently with Union law.[10] The Member States remain free to decide on the procedures for safeguarding the allocation of the power to impose taxes between them, on condition only that they do not contravene the freedoms of movement guaranteed by the Treaties.[11]

27. As regards more specifically the rules on double taxation, the somewhat paradoxical consequence of what I have just mentioned is that the Member States do not have any obligation under Union law to adopt measures to eliminate or limit the phenomenon. However, where they decide to do so, they are required to do so in accordance with Union law.[12] Apart from that cornerstone, the specific procedures for the action they take are left to the discretion of the Member States.[13]

28. Another cornerstone of the Court's case-law is that resident and non-resident taxpayers are, in principle, in different situations and therefore different tax treatment of them can be accepted by the Court *in principle*. If, however, the situation of the resident and the non-resident is exactly the same, different treatment would be discriminatory.[14] The tax legislation of a Member State can subject income earned by the same taxpayer within and outside the country to different treatment only where there are overriding reasons in the general interest which justify it.[15]

2. The effects of the German scheme

29. In order to express an opinion on the compatibility with the freedom of movement of capital of the German scheme to reduce double taxation, it is necessary to understand the way in which it functions in practice.

30. The point of departure, as we have seen above, consists in determining, in respect of income received abroad and taxed there by withholding at source, the theoretical German tax which would have been owed on that income if it had been received in Germany. That theoretical tax constitutes the maximum set-off which can be granted to compensate for what was paid to the foreign tax authorities. In practice the German legislature intended, following the OECD model, to establish the principle that a taxpayer cannot be given, as compensation for taxes paid abroad, a 'credit' greater than what the German tax authorities would have demanded in respect of the foreign income if it had been received in Germany.

31. In order to determine what the theoretical German tax on the foreign income is, a formula is used which, as pointed out above, multiplies the theoretical German tax on the total income to be taxed (national and foreign) by a fraction having foreign income in the numerator and total income in the denominator.

32. For ease of reference, I reproduce below the formula under consideration:

maximum set-off = total theoretical German tax x (foreign income/total income)

10 — See, for example, Case C-279/93 *Schumacker* [1995] ECR I-225, paragraph 21; Case C-346/04 *Conijn* [2006] ECR I-6137, paragraph 14; and Case C-298/05 *Columbus Container Services* [2007] ECR I-10451, paragraph 28.

11 — Case C-527/06 *Renneberg* [2008] ECR I-7735, paragraphs 48 and 50 and the case-law cited.

12 — Case C-194/06 *Orange European Smallcap Fund* [2008] ECR I-3747, paragraph 47.

13 — *Test Claimants in the FII Group Litigation*, cited in footnote 8, paragraph 48, and Joined Cases C-436/08 and C-437/08 *Haribo* [2011] ECR I-305, paragraph 86.

14 — *Renneberg*, cited in footnote 11, paragraph 60, and Case C-440/08 *Gielen* [2010] ECR I-2323, paragraphs 43 and 44.

15 — Case C-315/02 *Lenz* [2004] ECR I-7063, paragraphs 26 and 27; Case C-319/02 *Manninen* [2004] ECR I-7477, paragraph 29; and *Test Claimants in the FII Group Litigation*, cited in footnote 8, paragraph 46.

33. Since the total theoretical German tax is calculated not on the basis of the total income but rather a lower tax base (taxable income), the practical result of the formula is that the personal allowances, the application of which turns the total income into taxable income to be taxed (which is taken into account in determining the total theoretical German tax), is 'spread' over all the income, both the German and the foreign part. In the fraction contained in the formula both the numerator and the denominator are, as it were, 'gross' figures. Since personal allowances are not applied to foreign income, the German legislature considered it right to divide that income by the total income (foreign and German), gross of the personal allowances (on which it then used the total income and not the taxable income to be taxed). If, on the other hand, the denominator were taxable income, which is less than the total income, a higher value would be obtained for the 'foreign' part of the theoretical German tax and the set-off for the taxpayer would consequently be greater.

34. The approach which appears to have inspired the formula is that a resident taxpayer benefits completely from the personal allowances where all his income has been received in Germany. If, on the other hand, part of that income was received abroad, *the personal allowances apply, in fact, only to the German part of the income*, leaving the State in which the income was received the possibility of balancing the situation by granting the taxpayer a similar allowance.

35. A straightforward example may, perhaps, help explain the situation better. Let us imagine total revenue of EUR 100, of which EUR 70 is produced at home and EUR 30 abroad, a rate of 10% at home and abroad (for reasons of simplification, I will avoid introducing here an element of the progressive application of the tax, although it is generally present in reality) and an amount of possible personal allowances amounting to EUR 20. The result produced is as follows: Abroad, the taxpayer pays EUR 3 in tax (10% of EUR 30). In Germany a theoretical tax of EUR 8 is calculated (10% of EUR 80, which is the taxable income obtained by subtracting the personal allowances from the total income), and a tax credit of EUR 2.4 (8 x 30/100) is granted by applying the formula set out above. Therefore, the taxpayer pays in all EUR 5.6 in tax to the State of residence (EUR 8 – EUR 2.4 in tax credit), and EUR 3 to the foreign State where the income was produced, making a total of EUR 8.6. It is as if, on the EUR 70 of national income, a deduction were granted not of EUR 20, but of EUR 14, which is proportional to the income (70%) received within the country. It need scarcely be pointed out that if all the income were received in the State of residence, the tax paid would amount to EUR 8. If the foreign income did not exist, and the national income were was the only income, amounting to EUR 70, with personal allowances amounting to EUR 20, the tax to be paid in the State of residence would be EUR 5.

36. If the referring court's doubts were to be confirmed, and the formula for calculating the set-off were to use taxable income rather than total income in the denominator of the fraction, the maximum tax credit would amount to EUR 3 (8 x 30/80). Therefore, if the rates were the same at home and abroad, the total tax burden borne by the taxpayer would be the same, regardless of the location of his income.

3. Existence of a restriction of the free movement of capital

37. There is no doubt that the scheme under which set-off is limited to the tax which national law would levy on the foreign part of income is entirely lawful in the light of Union law, as has been confirmed by case-law.[16] Consequently, it is clear that Union law does not require a Member State to exempt a taxpayer from all the tax disadvantages which can arise from income being received in

16 — Case C-336/96 *Gilly* [1998] ECR I-2793, paragraph 48.

different States. Returning to the example in figures which I gave in the preceding point, if the rate applied in the State were higher than the German rate, German law could in no way be called upon to offset that difference. In any event, the tax credit would not go beyond what German tax law required with regard to domestic income of an amount equal to the foreign income. [17]

38. In other words, the mechanism which the German legislature decided to use poses no difficulty in principle. Neither the choice of a set-off scheme nor its limitation to a (notional) tax levied by German law on foreign income, give rise to any problems. However, uncertainty for the referring court is created by the *specific methods* by which that principle is put into practice and in particular the choice of using total income rather than taxable income as the denominator of the fraction.

39. In this regard the Court has consistently held that in principle it is the taxpayer's State of residence which has to take account of the factors relating to his personal and family circumstances. [18] Consequently, it is for the State of residence *to grant a taxpayer all the tax advantages resulting from the taking into account of his personal and family circumstances*, except where it is impossible in practice because of the *de minimis* nature or absence of revenue received in that State. In that case it is for the State in which the major part of the revenue was received to grant those advantages. [19]

40. However, as we have seen, under German law a taxpayer who has received part of his income abroad is granted tax advantages relating to his personal and family circumstances only in proportion to the national part of the income. Therefore, according to case-law in a situation such as that under consideration in the present case, in which a taxpayer earns a substantial part of his income in the Member State in which he is resident, but the Member State grants him only a fraction of the personal and family allowances, even though it takes account of all his income, the taxpayer in question is in a disadvantageous position compared to a taxpayer resident in the same State who has received all his revenue there and consequently all the allowances. Thus, such a situation constitutes a contravention of the fundamental freedoms guaranteed by the Treaty and specifically, in this case, the free movement of capital.

41. It is no coincidence that for some time certain German academic writers have been putting forward (well founded) doubts as to the compatibility with Union law, in the light in particular of the Court's case-law, of Article 34c of the EStG.

42. It is interesting to note that an almost identical situation was considered by the Court in *de Groot* [20] in which it found that a national mechanism for reducing double taxation based on a formula identical to that applied in German law, to which the present case relates, was incompatible with Union law.

43. Although the situation underlying the *de Groot* judgment displays certain differences from that of Mr and Mrs Beker, the central reasoning would appear to be entirely applicable. In that case too a taxpayer who had received income both in his own State of residence (the Netherlands) and abroad had been granted in the Member State of residence a tax advantage relating to his personal circumstances only in proportion to the part of the income received in that State. In practice, the

17 — It should further be emphasised that by definition the tax credit provided for in Article 34c of the EStG can never be greater than the tax actually paid abroad since it is not an exemption, but rather a set-off. In other words, a taxpayer who has received income abroad will in any event never pay less than he would have paid if he had received all his income in Germany.

18 — *Schumacker*, cited in footnote 10, paragraph 32; Case C-385/00 *de Groot* [2002] ECR I-11819, paragraph 90; and Case C-450/09 *Schröder* [2011] ECR I-2497, paragraph 37.

19 — *Schumacker*, cited in footnote 10, paragraph 36, and *Renneberg*, cited in footnote 11, paragraphs 61, 62 and 68.

20 — Cited in footnote 18.

mechanism for reducing double taxation used a formula identical to that under discussion here, in which the denominator of the fraction was the total income gross of personal or family allowances. The Court considered that that situation was contrary to the fundamental freedoms established by the Treaties. [21]

44. The fact that the Netherlands scheme discussed in *de Groot* provided, in order to reduce double taxation, for an exemption scheme and not a set-off scheme, as is the case under German law, is irrelevant. Firstly, the information on which the Court focussed its analysis in *de Groot* consisted of the formula used for the calculation and its practical effect, which was the same as in the present case, namely to limit certain tax advantages by granting them only in proportion to the part of the income received within the State of residence. Secondly, in actual fact the mechanism provided for in Netherlands law and considered in *de Groot* was a variant of the exemption scheme structured in such a way as to implement, in practice, a set-off scheme, as the Netherlands Government had itself pointed out at that time. [22]

45. The German Government has maintained, both in its written submissions and at the hearing, that the scheme under Article 34c of the EStG presents no problem in the light of the fundamental freedoms laid down in the Treaty since it grants the taxpayer all the personal and family allowances. That is because the total theoretical German tax in the first part of the formula is calculated taking account of all the allowances in question, and not only part thereof in proportion to the part of the income received in Germany. However, this argument weakens rather than reinforces the position of the German Government. It is readily apparent that the use in the first part of the formula of a total theoretical tax calculated taking account of all the personal and family allowances *reduces the maximum set-off* and thus *reduces the tax credit the taxpayer can enjoy*. If, on the other hand, the total German theoretical tax were calculated notionally for the purposes of the formula in question, without reducing the tax base by applying the personal and family allowances, the maximum set-off would be higher and the taxpayer would in the final analysis enjoy all the allowances in question rather than just a part proportional to the national fraction of his income.

46. I should add that in this case, unlike in *de Groot*, the income which the taxpayer received abroad is not revenue from work but from a shareholding. Consequently, the States in which that revenue was received have an even looser connection with the taxpayer than that which exists in cases such as *de Groot* in which the foreign income had a professional origin. It is unrealistic to imagine that each State in which Mr and Mrs Beker received part of their foreign income could grant them personal and family allowances on the part of the revenue earned there. Therefore, the approach which the Court took in *de Groot*, must, in my view, be adopted even more clearly in this case.

47. Finally, as regards the nature of the tax allowances granted to the taxpayer, it is generally for the national court to establish, on the basis of national law, whether or not they are personal and/or family allowances. In the present case, the wording of the question referred mentions the fact that at least some of the denied allowances are of that nature.

21 — *de Groot*, cited in footnote 18, paragraphs 89 to 95. Incidentally, in *de Groot* the freedom on the basis of which the situation was assessed was that of the movement of workers.

22 — See, in that respect, the Opinion of Advocate General Léger delivered on 20 June 2002 in the case of *de Groot*, decided by the judgment cited in footnote 18, paragraph 34. Usually a double taxation reduction scheme based on the exemption mechanism is characterised by the fact that the State of residence does not tax income in the State in which it was received. The Netherlands legislation under discussion in *de Groot* was in actual fact based on a typical set-off mechanism. The only visible difference compared with the German rule to which the present case relates is that in the Netherlands scheme the amount of the tax credit granted was, as an exemption, awarded without establishing whether it was greater than the tax actually paid abroad, as is the case under a set-off scheme. By definition, a set-off scheme always sets off (part of the) tax already paid in the State where the income was received.

4. Possibility of justification

48. Now that it has been established that the German scheme that has just been considered constitutes a restriction on the free movement of capital contrary to the Treaty, it must naturally now be established whether that scheme can be justified.

49. The German Government, which dealt briefly with possible justification in its written observations, put forward, merely in the alternative, a single ground relating to safeguarding the allocation of the power to impose taxes. Essentially, it claims that Germany has the right, as a consequence of that principle, to grant tax advantages solely in proportion to the 'German' part of income and cannot be required to compensate for the fact that such advantages are not granted in foreign States in which part of the income was received.

50. In general, safeguarding the allocation of the power to impose taxes between the Member States can, according to case-law, constitute an overriding reason in the public interest capable of justifying restrictions on fundamental freedoms, on condition that the measures taken are appropriate for pursing the objective in question and do not go beyond what is necessary for that purpose. [23]

51. Such a justification has, however, been expressly rejected by the Court in circumstances similar to those of the present case, in the *de Groot* judgment. In that judgment the Court held in particular that the allocation of the power to impose taxes cannot be invoked by a taxpayer's State of residence in order to evade the responsibility on it in principle to grant the personal and family allowance to which the taxpayer is entitled. [24] That is the case unless, intentionally or as a consequence of specific international agreements, the foreign States in which part of the income is received do not grant such allowances. [25]

52. In any event, whatever the Court's findings in *de Groot* it should be noted that the disadvantageous situation of taxpayers such as Mr and Mrs Beker does not result from the parallel exercise of fiscal jurisdiction by several States. As the Commission rightly pointed out, by granting Mr and Mrs Beker the personal and family allowances in full the German tax authorities in no way concede part of their fiscal jurisdiction to other States. If the German part of the income is considered, it would have been taxed in any event – the personal and family allowances being equal – no less than it would have been if it had been the taxpayer's only income and he had received no income abroad.

53. Moreover, it is settled case-law that a mere loss of tax revenue can never be relied upon to justify measures contrary to a fundamental freedom. [26]

54. In the final analysis, the point at issue is the interpretation to be placed, in general, on the personal and family allowances. In the view of the German Government, the fact that they are allowances which can be allocated not to a specific part of the income but to the taxpayer's person means that they must be regarded as 'spread', that is to say attributable homogeneously to all income, domestic and foreign, and therefore the grant thereof, in the case of revenue received only in part in Germany, can be limited to a fraction proportionate to the amount of that income as part of the taxpayer's total income. Conversely, in the interpretation arising from the Court's case-law, the absence of any link between personal and family allowances and a specific part of income means that, far from being capable of being spread uniformly over all the revenue – domestic and foreign – they must in principle *be applied in full to the part of the income in the State of residence*.

23 — *Haribo*, cited in footnote 13, paragraphs 121 to 122 and the case-law cited.

24 — *de Groot*, cited in footnote 18, paragraph 98.

25 — Ibid., paragraphs 99 and 100.

26 — Ibid., paragraph 103. See also Case C-386/04 *Centro di Musicologia Walter Stauffer* [2006] ECR I-8203, paragraph 59, and *Haribo*, cited in footnote 13, paragraph 126.

55. Therefore, since safeguarding the allocation of the power to impose taxes cannot be invoked as justification in this case, it is not necessary to establish whether the German rules satisfy the requirements relating to the appropriateness and proportionality of the measures concerned.

56. Finally, the possibility that the German legislation could be justified in the light of the need to safeguard the coherence of a tax system can also be ruled out. Although such a need can in principle provide grounds for a valid restriction on the fundamental freedoms,[27] it presupposes that a precise compensatory effect is demonstrated between a tax advantage and a specific tax for the purpose of preserving an essential element of the tax system.[28] The present case does not involve a situation of that kind. Granting all the personal and family allowances to a taxpayer does not conflict with any essential element of German tax and does not cast any doubt on the principle relating to the progressive application of the tax. Significantly, that justification was not relied on by the German Government in its observations.

5. Possibility of opting for an alternative scheme

57. A final point requiring clarification concerns the fact that the German scheme allows the taxpayer to exercise his right to opt for a scheme other than tax calculation. Where the taxpayer exercises that option, the set-off mechanism is not applied and the tax paid abroad is deducted from the overall tax base.

58. In practice, exercise of the option brings about a 'classic' situation of double taxation in which the State of residence considers that all income acquired by the taxpayer both at home and abroad is taxable. The taxes paid abroad are taken into consideration not as duties, but merely as a factor which reduced the foreign part of the income and the remaining part is then normally taxed in the State of residence.

59. To take up the example in figures which I used in point 35 above, assuming a total income of EUR 100, of which EUR 70 is received at home and EUR 30 abroad, with a rate of 10% both at home and abroad and an amount of possible personal allowances of EUR 20, the result would be as follows under the option scheme. Abroad, the taxpayer pays EUR 3 in tax (10% of EUR 30). In Germany the tax is calculated on a tax base of EUR 77, obtained by subtracting EUR 20 in personal allowances from the total revenue of EUR 97 (EUR 70 of 'German' revenue and EUR 27 of 'foreign' revenue). This produces a German tax of EUR 7.7, which, added to the EUR 3 already paid abroad, gives a total amount, payable by the taxpayer, of EUR 10.7.

60. As can be seen, exercising the option, and thus the choice of a model in which double taxation is not reduced, generally does not suit the taxpayer. However, as I noted above, Union law does not require that double taxation be eliminated or reduced and does not intervene until States adopt measure for that purpose. They are not obliged to do so, and therefore it cannot be excluded that a scheme such as that described above could be regarded as compatible with the treaties where the taxpayer exercises that option. Therefore, the question arises as to whether the possibility given to the taxpayer to opt for a legal regime which is generally less advantageous, but not incompatible with Union law, renders the tax system under consideration compatible as a whole.

27 — See, for example, Case C-418/07 *Papillon* [2008] ECR I-8947, paragraph 43 and the cited case-law.

28 — *Manninen*, cited in footnote 15, paragraph 42 and the cited case-law.

61. The answer is that it is not. The case-law of the Court has made clear that the existence of an option, which might make it possible to render a situation compatible with Union law, does not remedy the unlawfulness of a scheme which includes a tax mechanism which is incompatible with the Treaties.[29] In my view, this is particularly true where, as in this case, the unlawful mechanism is the one which is applied automatically where the taxpayer makes does not make a choice.[30]

62. Therefore, it is not necessary to carry out a detailed examination of the taxation mechanism which is set in motion when a taxpayer exercises the abovementioned option. The existence of the option, even though it opens the door to a scheme which poses no problems in terms of compatibility with Union law, does not render lawful the double taxation reduction mechanism which is applied where the option is not exercised.

IV – Conclusion

63. In the light of the foregoing considerations, I propose that the Court should reply as follows to the question referred by the Bundesfinanzhof:

Article 63 TFEU precludes a rule in a Member State by which, as part of a regime to reduce double taxation, the set-off mechanism is applied by laying down a maximum set-off determined by multiplying the theoretical national income tax, calculated on the basis of the taxable income, including foreign income, by a fraction having as its numerator the total foreign income and as its denominator the taxpayer's total income with no deduction for personal and family allowances.

29 — *Gielen*, cited in footnote 14, paragraphs 49 to 52.

30 — See also my Opinion in Case C-569/07 *HSBC Holdings and Vidacos Nominees* [2009] ECR I-9047, delivered on 18 March 2009, paragraphs 69 to 72.