

# Newsflash

## EU Direct Tax Group

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### EU Direct Tax Group

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#### Denial of loss deduction and disadvantageous method of depreciation in relation to real estate situated in another Member State restricts freedom of capital movement

The ECJ ruled on 15 October 2009 that Art. 56 EC precludes tax provisions which allow the deduction of losses from letting or leasing of immovable property and the application of the declining balance method of depreciation only if the property is situated in the same Member State (MS).

Siblings Ms Busley and Mr Cibrian Fernandez inherited a house in Spain as joint heirs from their parents in 1996 which they, as they continued to live in Germany, started to let from 2001 onwards. In their tax returns for 1997 to 2003 filed in Germany as their country of residence, Busley and Cibrian requested the application of the decreasing-balance method of depreciation as well as the offset of losses generated by the letting of the house in Spain. The German tax authority, however, rejected the application as German income tax law grants the decreasing-balance method of depreciation only under the condition that the real estate is situated within Germany. Also, the offset of losses arising from letting of real estate was at the time limited to profits generated in the same MS where the property is located. Where losses generated in another MS could not be taken into account in the same fiscal year, they could only be offset against profits - if any - from that MS and of the same nature (e.g., letting or leasing) in a subsequent period.

Upon appeal, the ECJ stated that Art. 56 EC does not only apply to situations where tax provisions discourage investments in other MS but also where a person is discouraged from the retention of property in another MS. Answering the referring court's question on the relevance of the fact that the property was inherited, the ECJ also established with reference to the Annex I of Directive 88/361 that an inheritance consisting in the transfer of assets, including immovable property, from the deceased to one or more persons falls within the scope of the freedom of capital movement.

The Court argued that the tax position of a natural person resident in one MS who has immovable property in another MS is less favourable than if the immovable property were located in the same MS. The provisions at hand thus constitute a restriction of the movement of capital as residents with foreign property would suffer though not ultimate but cash-flow disadvantages. While residents with domestic property could offset losses immediately, residents with property in another MS could only offset losses with later profits from that MS. Likewise, a person with domestic property could initially apply a higher depreciation rate than a person who holds immovable property abroad and may only apply the straight-line depreciation method.

The ECJ rejected a justification based on the principle of territoriality since that principle would simply not preclude taking foreign losses into account. Germany had further held that a restriction could be justified as the preferential depreciation method serves the public interest for satisfying demand of housing in Germany. For that, the Court argued, the provision was drafted too broadly as all housing projects were covered and not only areas where demand was high. The Court thus found the provision was not appropriate for attaining the stated objective, and found a restriction of Art. 56 EC to be at hand.

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