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THE *SAINT-GOBAIN* JUDGMENT OF THE ECJ

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In the recently delivered *Saint-Gobain* judgment the European Court of Justice (ECJ) held that the German taxation of permanent establishments of EC corporations was contrary to the freedom of establishment under EC law.[2]

The *Saint-Gobain* judgment will have a strong impact on the taxation of permanent establishments that reaches beyond the particular case and the provisions concerned. The considerations of the Court will be applicable to other instances of discrimination against branches in Germany and other Member States. The Court has extended the principle of equal treatment of branches to concessions granted by the host Member State under double taxation treaties with both other Member States and third countries as treaty partners. This is a new dimension of the Court's consistent case law in the area of direct taxes and fundamental freedoms of the EC Treaty.

1. Facts of the case and legal background

The facts of the case and the legal background can be summarised as follows:[3] Compagnie de Saint-Gobain SA is a French stock corporation whose seat and business management are located in France. The company has been carrying on business for 150 years through a branch office in Germany. For the purposes of German tax law the branch is treated as a permanent establishment, i.e. Saint-Gobain SA is subject to limited tax liability because neither its seat nor its business

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2 ECJ judgment of 21st September 1999 in Case C-307/97 *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland vs. Finanzamt Aachen-Innenstadt*, not yet published in ECR. Saint-Gobain was represented by Professor Dr Albert J Rädler and Dr Martin Lausterer of Oppenhoff & Rädler Linklaters & Alliance, Munich.

3 For a more detailed analysis of the facts and the legal background of the *Saint-Gobain* case see Lausterer, ECTJ 3/1 [1998] 35.

management are located in Germany.[4] Under the limited tax liability, income from an industrial and commercial establishment located within German territory forms part of domestic income,[5] and the capital used in the establishment forms part of the domestic assets for net worth tax.[6] In 1988, the relevant year in the main proceedings, Saint-Gobain SA held, through its German branch, shareholdings in a US, a Swiss, an Austrian and an Italian corporation and received dividends from each of these foreign subsidiaries.

The tax office refused to grant Saint-Gobain certain tax concessions namely:

- exemption from German corporation tax for the dividends received from the US and the Swiss subsidiary provided for by the double taxation treaties concluded between Germany and each of those two non-EC-member countries (corporation tax relief for international groups);

- the crediting, against German corporation tax on dividends received from the Austrian and the Italian subsidiary, of the corporation tax levied on the profits of the subsidiaries in the country of their residence (indirect tax credit[7]);

- exemption from German net worth tax for shareholdings in the US subsidiary (net worth tax relief for international groups[8]).

All these concessions were refused on the ground that the applicable tax treaties in the case of the corporation tax relief for international groups, and German domestic law in the two other cases, restrict the concessions to German resident corporations subject to unlimited tax liability in Germany.

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4 Sec. 2 (1) KStG - *Körperschaftsteuergesetz*, German Corporation Tax Code, and sec. 2 (1) (2) VStG - *Vermögensteuergesetz*, German Net Worth Tax Code.

5 Sec. 8 (1) KStG combined with sec. 49 (1) (2) (a) EStG - *Einkommensteuergesetz*, German Income Tax Code.

6 Sec. 121 (2) (3) BewG - *Bewertungsgesetz*, German Valuation Code.

7 The indirect tax credit under sec. 26 (2) KStG is a domestic measure to reduce double taxation of dividends in cases where no tax treaty exists with the country of the subsidiary or where the applicable treaty does not provide for an exemption of foreign dividends. For the year 1988, the applicable respective German tax treaties with Austria and Italy did not provide for an exemption of inter-corporate dividends paid by the subsidiaries in Austria and Italy.

8 Sec. 102 BewG.

Saint-Gobain considered that it was contrary to the freedom of establishment under the EC Treaty[9] for the German permanent establishment of a corporation established in France to be excluded from the benefit of these three tax concessions designed to avoid or at least diminish economic double taxation on inter-corporate shareholdings. Therefore, Saint-Gobain challenged the tax assessments before the Tax Court in Cologne which decided to stay proceedings and to refer the relevant questions to the ECJ.[10]

II. Judgment and main considerations of the Court

In answer to the questions referred to it, the ECJ upheld the position of Saint-Gobain and ruled that Article 52 (now, after amendment, Article 43) and Article 58 (now Article 48) of the EC Treaty preclude the exclusion of a permanent establishment in Germany of a corporation having its seat in another Member State from enjoyment, on the same conditions as those applicable to corporations having their seat in Germany, of the tax concessions in question.

The ECJ based this answer to the questions referred to it by the Tax Court Cologne mainly on the considerations set out below:

1. Disguised discrimination

The Court referred to its settled case-law[11] according to which Article 52 of the Treaty constitutes a fundamental provision which has been directly applicable in the Member States since the end of the transitional period.

The freedom of establishment guarantees nationals of the EC Member States who have exercised their freedom of establishment and companies or firms which are assimilated to them the same treatment in the host Member State as that accorded to nationals of that Member State. As far as companies or firms are concerned, their corporate seat serves to determine, like nationality for natural persons, their

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9 Articles 52 and 58 (now Articles 43 and 48) of the EC Treaty.

10 Tax Court Cologne, court order of 30th June 1997, docket no. 13 K 4342/91, *Entscheidungen der Finanzgerichte* 1997 p. 1056, *Internationales Steuerrecht* 1997 p. 557 with an annotation of Lausterer.

11 See, in particular, the judgments of 28th April 1977 in Case 71/76 *Thieffry* [1977] ECR 765; of 23rd January 1986 in Case 270/83 *Commission v France (Avoir Fiscal)* [1986] ECR 273, paragraph 13; and of 29th April 1999 in Case C-311/97 *Royal Bank of Scotland*, paragraph 22.

connection to a Member State's legal order.[12] The refusal to grant the tax concessions in question affected in principle companies not resident in Germany and was based on the criterion of the company's corporate seat in determining the applicable tax rules.

2. Unequal treatment and restriction of the freedom of establishment

For those companies to which they are granted, the tax concessions result in a lighter tax burden, so that the permanent establishments of companies having their corporate seat in another Member State ("non-resident companies") are in a less favourable situation than resident companies, including German subsidiaries of non-resident companies. In those circumstances, the refusal to grant the tax concessions in question to the permanent establishments in Germany makes it less attractive for non-resident companies to have inter-corporate holdings through German branches, and thus restricts the freedom to choose the most appropriate legal form for the pursuit of activities in another Member State.

The difference in treatment to which branches of non-resident companies are subject in comparison with resident companies, as well as the restriction on the freedom to choose the most appropriate legal form of secondary establishment, must be regarded as constituting a single composite infringement of the freedom of establishment under Articles 52 and 58 of the EC Treaty.

3. No justification for the unequal treatment

All arguments which were brought forward to justify that difference in treatment were rejected by the Court.

(a) Resident and non-resident companies are in comparable situations

The German Government had argued that the situations of resident and non-resident companies are not, as a general rule, comparable. Resident companies are subject to unlimited tax liability on their global income and assets whereas non-resident companies are subject to limited tax liability on their domestic income and assets. The Court responded that both are in objectively comparable situations because the dividend receipts in Germany and the shareholdings in foreign subsidiaries are liable

12 See ECJ judgments of 23rd January 1986 in Case 270/83 *Avoir Fiscal,* cited above, paragraph 18; of 13th July 1993 in Case C-330/91 *Commerzbank* [1993] ECR I-4017, paragraph 13; and of 16th July 1998 in Case C-264/96 *ICI* [1998] ECR I-4695, paragraph 20.

to tax in Germany irrespective of whether they are held by a resident company or by a non-resident company. The situations of resident and non-resident companies are made even more comparable by the fact that the difference in treatment applies only as regards the grant of the tax concessions in question. Tax liability of non-resident companies, theoretically limited to domestic income and assets, comprises in actual fact dividends from foreign sources and shareholdings in foreign companies, whereas tax liability of resident companies, theoretically extending to global income and assets, does not in actual fact, through the grant of the concessions in question, include dividends received from and shareholdings in foreign companies.

(b) No compensation of disadvantages with other possible advantages

It was further argued that the refusal of certain tax concessions to non-resident companies is justified by the need to prevent a reduction in tax revenue and by the advantage which permanent branches enjoy in comparison with resident subsidiaries as regards the transfer of profits to the non-resident parent company. The tax concessions in question, if granted to resident companies, result in a loss of revenue but are partially compensated by the taxation of the dividends distributed, whereas the like grant to a permanent establishment would not be so compensated. The same would confer an advantage on the permanent establishments, the profits of which are also not taken into account in the event of subsequent distributions whereas, in the case of resident companies, profits are still subject to taxation at a later stage in the event of distribution of dividends to shareholders.

The Court responded that a reduction in tax revenue is not one of the grounds listed in Article 56 (now, after amendment, Article 46) of the EC Treaty and cannot be regarded as a matter of overriding general interest which may be relied upon in order to justify unequal treatment that is in principle incompatible with Article 52 of the Treaty.[13] Further, the Court observed that the difference in tax treatment between resident companies and branches cannot be justified by other advantages which branches may enjoy in comparison with resident companies and which will compensate for the disadvantages of not being allowed the tax concessions in question. Even if such advantages exist, they cannot justify breach of the obligation laid down in Article 52 of the Treaty to accord the same domestic treatment concerning the tax concessions in question.[14]

13 See, to this effect, the Court's judgment of 16th July 1998 in Case C-264/96 *ICI*, cited above, paragraph 28.

14 See, to this effect, the Court's judgment of 23rd January 1986 in Case 270/83 *Avoir Fiscal,* cited above, paragraph 21.

(c) Community law overrides double taxation treaties

Finally, the German Government argued that the conclusion of bilateral treaties with a non-member country does not come within the sphere of Community competence. In the absence of Community harmonisation in this area, the question of whether, in the case of dividends, the tax exemption for international groups should be granted to permanent establishments under a tax treaty concluded with a non-member country is not governed by EC law. It would not be compatible with the division of competences under Community law to extend to other situations the tax advantages provided for by double taxation treaties concluded with non-member countries. In this respect the Swedish Government observed that double taxation treaties are based on the principle of reciprocity and that the balance inherent in such treaties would be disturbed if the benefit of their provisions was extended to companies established in Member States which were not parties to them.

The Court observed that, in the absence of unifying or harmonising measures adopted in the Community[15], the Member States remain competent to determine the criteria for taxation of income and worth with a view to eliminating double taxation by means, *inter alia*, of international agreements, and the Member States are at liberty, in the framework of bilateral agreements concluded in order to prevent double taxation, to determine the connecting factors for the purposes of allocating powers of taxation as between themselves.[16]

As far as the exercise of the power of taxation so allocated is concerned, the Member States nevertheless may not disregard Community rules. Although direct taxation is a matter for the Member States, they must exercise their taxation powers consistently with Community law.[17] In the case of a double taxation treaty concluded between a Member State and a non-member country, the national treatment principle requires the Member State which is party to the treaty to grant to permanent establishments of non-resident companies the advantages provided for by that treaty on the same conditions as those which apply to resident companies.

15 In particular under the second indent of Article 220 (now Article 293) of the EC Treaty.

16 See, to this effect, the Court's judgment of 12th May 1998 in Case C-336/96 *Gilly*, [1998] ECR I-2793, paragraphs 24 and 30.

17 See the Court's judgments of 14th February 1995 in Case C-279/93 *Schumacker* [1995] ECR I-225, paragraph 21; of 11th August 1995 in Case C-80/94 *Wielockx* [1995] ECR I-2493, paragraph 16; of 27th June 1996 in Case C-107/94 *Asscher* [1996] ECR I-3089, paragraph 36; of 15th May 1997 in Case C-250/95 *Futura Participations and Singer* [1997] ECR I-2471, paragraph 19; of 28th April 1998 in Case C-118/96 *Safir* [1998] ECR I-1897, paragraph 21; and of 16th July 1998 in Case C-264/96 *ICI*, cited above, paragraph 19.

The obligations which Community law imposes on Germany do not affect in any way those resulting from its agreements with the United States and Switzerland.[18] The balance and the reciprocity of the treaties concluded by Germany with those two countries would not be called into question by a unilateral extension, on the part of Germany, of the category of recipients in Germany of the corporation tax relief for international groups, since such an extension would not in any way affect the rights of the non-member countries which are parties to the treaties and would not impose any new obligation on them.

Moreover, the German legislature has never considered that the provisions of the double taxation treaties concluded with non-member countries precluded any unilateral renunciation by Germany of levies on dividends from shareholdings in foreign companies since, in 1983, it unilaterally reduced the requirement for the corporation tax concessions of a minimum participation in the voting shares under a tax treaty to at least 10%[19], and, in 1993, it unilaterally extended the corporation tax concessions to permanent establishments of non-resident companies.

III Comments

It is worth noting that only a few Member States participated in the *Saint-Gobain* proceedings before the ECJ.[20] Aside from the German Government only the Swedish and the Portuguese Government submitted written observations.[21] Neither these two nor any other Member States submitted oral observations at the hearing on 19th January 1999.

The views of the ECJ will be applicable to other instances of discrimination against permanent establishments in Germany and other Member States. A special aspect of the decision is that, under the EC Treaty, permanent establishments are generally entitled to the benefits under double taxation treaties of the Member State in which the permanent establishment is located, both with other Member States as well as third countries as treaty partners. This benefit might be limited so that it applies only to the core area of the fundamental freedoms.

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18 See, to this effect, the Opinion of Advocate General Jean Mischo of 2nd March 1999 in Case C-307/97 *Saint-Gobain*, point 81.

19 § 26 (7) KStG in the then applicable version of the law; now § 8b (5) KStG.

20 In fact, it is amazing that in almost all proceedings before the ECJ in direct tax matters most Member States were reluctant to submit written and/or oral observations apart from the Member State whose tax regime was directly concerned by the proceedings.

21 Further, the parties to the main proceedings and, as in all cases proceedings before the Court, the Commission submitted written observations.

With respect to the taxation of foreign dividends, the ECJ did not give consideration to a distinction between the indirect foreign tax credit and the exemption under a tax treaty. It had been suggested in tax literature[22] that Germany should be obliged to concede the indirect foreign tax credit which it gives to a resident under purely internal law, but that the tax exemption for inter-company dividends under a bilateral tax treaty should not be given to permanent establishments as a result of the EC Treaty provisions. The main argument[23] against this approach is that there is no substantial difference between the concessions. Once given force by ratification, tax treaties constitute internal law of equal status to other statutory tax law.[24]

It should be noted that the domestic legal context was changed, with effect from the 1994 tax period, by the introductions of new provisions according to which (1) the exemption of foreign dividends from German corporation tax granted under double taxation treaties to German resident companies was extended to permanent establishments[25], and (2) the indirect tax credit for foreign dividends was also granted to permanent establishments.[26] According to the legislative reasoning for the introduction of the provisions the reason for the amendment was: "The equal treatment between the permanent establishment of a foreign company and a company subject to unlimited tax liability takes into account the freedom of establishment provided for in Article 52 of the EEC Treaty and excludes discrimination prohibited by those provisions."[27] Although the German legislator had admitted that there was prohibited discrimination of permanent establishments this acknowledgement was not decisive for the ECJ when interpreting the Treaty provisions.[28] However, the unilateral extension of the corporation tax concessions in bilateral treaties to permanent establishments of non-resident companies clearly contradicted the justification argument to the effect that the principle of reciprocity and the balance inherent in bilateral tax treaties with third countries would be disturbed if the benefit of their provisions was extended to permanent establishments.

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22 See J F Avery Jones, *EC Tax Review* 1998, p. 95, 103.

23 See Lausterer, ECTJ 3/1 [1998] 35, 49.

24 See, to this effect, the Opinion of Advocate General Jean Mischo, point 77.

25 Sec. 8b (4) KStG.

26 Sec. 26 (7) KStG.

27 *Bundesratsdrucksache* (Federal Council Publication) 1/93, p. 40.

28 See, to this effect, the Opinion of Advocate General Jean Mischo, point 81.

Further, net worth tax has not been levied since January 1997 on the ground that it is in part unconstitutional, as found by the German Constitutional Court in its judgment of 22nd June 1995.[29]

Thus, the discrimination against permanent establishments that was the concrete issue of the present case has largely been ended. Nevertheless, the judgment will have a strong impact on the taxation of permanent establishments that reaches beyond the particular case and the provisions concerned.

However, the discrimination alleged in the Saint-Gobain case is not the only difference in the tax treatment of German resident and non-resident companies.

As regards foreign dividends, there remains discrimination at the level of a permanent establishment if the German branch has a domestic subsidiary receiving foreign dividends for which the exemption under a double taxation treaty freely applies. The dividends received by the German intermediate holding company from its foreign subsidiary are exempt from German corporate income tax under an applicable German tax treaty. However, upon redistribution of the foreign dividends by the German intermediate company to the German permanent establishment of a non-resident company, the dividends would be subject to German corporate income taxation, at the level of the permanent establishment, because the inter-company exemption privilege on the re-distribution of foreign dividends under German domestic law, which was introduced for taxable years as of 1994, applies only if the recipient is a German resident corporation. It does not apply if the recipient is a non-resident corporation, such as the permanent establishment of a foreign company[30]. It seems rather obvious that this result of the German tax provisions constitutes an infringement of the right of establishment under Article 52 (now Article 43) of the EC Treaty. Even if a German permanent establishment of a foreign EC-resident company would otherwise fulfil all requirements for the tax exemption of the dividends in this situation, the exemption would be denied for the sole reason that the recipient is a non-resident taxpayer.

A rather well-known example of different tax rules for resident and non-resident corporations concerns the higher corporation tax rate for German permanent establishments of non-resident corporations and for non-resident partners in a German partnership as compared to German resident companies (subsidiaries).[31] Presently, permanent establishments of non-resident corporations are subject to a flat corporation tax rate of 40% compared to a split-rate for resident corporations of 30%

29 Judgment of 22nd June 1995, docket no. 2 BvL 37/91, BStBl. II 1995 p. 655.

30 No application of sec. 8b (1) and (4) KStG.

31 For details see Rädler/Lausterer, *Der Betrieb* 1994, p. 699.

for distributed profits (plus dividend withholding tax, if any) and 40% for undistributed profits. Thus, permanent establishments are excluded from the possibility of benefiting from the lower rate of tax on profits whereas resident companies (subsidiaries) benefit from the lower tax rate to the extent that they distribute their profits.[32]

Another potential discrimination issue concerns the possibility for a tax-free conversion of a participation in a German partnership by a non-resident partner into a corporation. At present, a tax-neutral conversion of a partnership into a corporation is only allowed if the partner is a German resident.

32 See, to this effect, also the Court's judgment of 29th April 1999 in Case C-311/97 *Royal Bank of Scotland,* cited above, on different tax rates for EC companies having established a branch in Greece as compared to companies resident in Greece. The Court held that the freedom of establishment precludes legislation of a Member State according to which the non-resident company is always subject to a higher tax rate whereas resident companies may benefit from a lower tax rate.