The EC Tax Journal

UNLAWFUL GERMAN TAX DISCRIMINATION OF PERMANENT ESTABLISHMENTS COMES BEFORE THE EUROPEAN COURT OF JUSTICE

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I Introduction and questions referred to the ECJ

In its landmark decision of 1986 in the *avoir fiscal* case[2] the European Court of Justice (ECJ) held that the French taxation of permanent establishments of EC resident corporations was unlawful under the freedom of establishment guaranteed by Article 52, 58 of the EEC Treaty. Ever since it has been argued in German tax literature that some of the existing differences in the tax treatment of German permanent establishments of foreign EC resident corporations as compared to German resident corporations constitute an infringement of the freedom of establishment under Article 52, 58 of the EEC Treaty (now EC Treaty). However, up until now, German tax courts have not referred any case to the ECJ for a preliminary ruling concerning the compatibility of the German taxation of permanent establishments with Articles 52, 58 of the EEC/EC Treaty.

In a case which has been pending since 1991 before the Tax Court of Cologne the plaintiff (the German permanent establishment of a French corporation) sought the granting of the exemption privilege under German tax treaties and the indirect tax credit under German domestic law for inter-company dividends which the German permanent establishment had received from foreign subsidiaries in 1988; the plaintiff

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2 ECJ judgment of 23rd January 1986, case 270/83, *Commission/France*,1986 ECR [1986] 273. The ECJ confirmed this decision in the subsequent *Commerzbank* case, ECJ judgment of 13th July 1993, case C-330/91, *Commerzbank*,1993 ECR [1993] I-4017; see also ECJ judgment of 12th April 1994, case C-1/93, *Halliburton*,1994 ECR [1994] I-1137.

further requested the exemption of the shares for net worth tax purposes. The plaintiff based its claims on the freedom of establishment under Articles 52, 58 EEC Treaty and suggested a submission to the ECJ. In a court order of 30th June 1997[3], the Tax Court Cologne submitted the following three questions to the ECJ for a preliminary ruling under Article 177 of the EEC Treaty:

"1. Is it compatible with the applicable Community law, and in particular with Articles 52 and 58 of the EC Treaty, read together, for a branch establishment of a company having its seat in another Member State not to be accorded *Schachtelprivileg* (a form of tax relief in respect of profits distributed between parent company and subsidiary) in respect of dividends under a double taxation agreement with a non-member State under the same conditions as for a company having its seat in Germany?

2. Is it compatible with the applicable Community law, and in particular with Articles 52 and 58 of the EC Treaty, read together, for the tax levied in a non-member State on the profits of a subsidiary in that State of a branch establishment in Germany of a company having its seat in another Member State not to be credited against the German corporation tax on that branch establishment under the same conditions as for a company having its seat in Germany?

3. Is it compatible with the applicable Community law, and in particular with Articles 52 and 58 of the EC Treaty, read together, for a branch establishment in Germany of a company having its seat in another Member State not to be accorded *Schachtelprivileg* in respect of capital tax under the same conditions as for a company having its seat in Germany?" [4]

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3 Tax Court of Cologne, court order (*Beschluß*) of 30th June 1997, case no. 13 K 4342/91, EFG 1997 p. 1056, IStR 1997, p. 557.

4 The request for a preliminary ruling was registered as case C-307/97, *Saint Gobain* the Court Register of the ECJ, OJ C 318 of 18th October 1997, p. 11.

Although the questions[5] referred to the ECJ are, to some extent, only relevant for taxable years before 1994[6], the judgment of the ECJ will be of fundamental importance for the taxation of permanent establishments in Germany of EC residents

II Facts of the case

The facts of the case referred to the ECJ are described in the court order as follows:

The plaintiff, a stock corporation established under French law, since the early twenties has a registered branch office (permanent establishment) in Germany and was carrying out business activities in Germany and directly and indirectly holding participations in corporations located outside Germany (foreign subsidiaries). The plaintiff as a German permanent establishment is subject to limited tax liability on its German income and on its German assets.

During the taxable year at issue, the following participations were attributed to the German permanent establishment for tax purposes:

- a direct participation of more than 10 % in a US corporation;

- via two different German intermediate subsidiaries – the shares of each of which were almost exclusively held by the permanent establishment and with each of which there was in place a valid agreement on tax integration under German domestic tax law (*Organvertrag*) – an indirect participation of 33 % in a Swiss corporation, of 47 % in an Austrian corporation, and of 25% in an Italian corporation, respectively.

In 1988, the year at issue, the German permanent establishment received dividends from each of its foreign subsidiaries, including dividends from its indirect (second-tier) foreign subsidiaries. Under the German rules on tax integration (*Organschaft*), the dividends paid to the German intermediate subsidiaries (the dominated entities) were

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5 The questions submitted by the Tax Court of Cologne refer to the articles of the "EEC Treaty" whereas the questions as published in the OJ refer to the articles of the "EC Treaty" which from a formal point of view is not right. The legal basis for the year in issue (1988) actually is the "EEC Treaty". The European Economic Community was renamed the European Community by Article G of the Maastricht Treaty of 7th February 1992 which entered into force on 1st November 1993. Article G of the Maastricht Treaty also amended the provisions of the EEC/EC Treaty. However, Articles 52 and 58 remained unchanged by those amendments.

6 In particular the questions listed under numbers 2 and 3 are of limited relevance because of changes in German domestic tax law; see the comments below at III.

attributed to the dominating entity i.e. to the German permanent establishment of the French company, for corporate income tax purposes. The dividends were subject to dividend withholding tax in the respective foreign jurisdictions.

On the basis of the non-discrimination provisions of Article 52, 58 EEC Treaty (giving freedom of establishment), the German permanent establishment applied for the following:

- the exemption from German corporate income tax of the dividends paid by the US and the Swiss subsidiary under the exemption privilege for inter-company dividends of the then applicable version of the German tax treaties with the US and Switzerland, respectively;

- the granting of the foreign indirect tax credit for the inter-company dividends paid by the subsidiaries in Austria and Italy under German domestic law (§ 26 (2) KStG)[7]; for the year 1988, the applicable respective German tax treaties with Austria and Italy did not provide for an exemption privilege for the dividends paid by the subsidiaries in Austria and Italy;

- the exemption from German net worth tax (*Vermögensteuer*) for the directly held shares in the US subsidiary (according to § 102 (2) BewG[8]).

The applications were rejected by the local tax office (Aachen-Innenstadt) under the then applicable German tax treaties and the respective provisions of German national tax law. However, if the German permanent establishment of the French corporation had been a subsidiary, i.e. a German resident company, then the benefits applied for would have been granted.

III Analysis of the legal situation under German national law

The Tax Court of Cologne stated in its court order that the plaintiff's application is unfounded so far as German national law is concerned. However, in view of the jurisprudence of the ECJ it considered an interpretation of Community law to be necessary.

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7 *Körperschaftsteuergesetz*, German Corporate Income tax Code.

8 *Bewertungsgesetz*, German Valuation Code.

In order to determine the existence of discrimination against the German permanent establishment of the French company as compared to a German resident corporation, the tax treatment of both permanent establishment and German resident corporation has to be compared. For a comparison of corporate income tax one has to distinguish between those situations in which there is a double tax treaty with the state of residence of the foreign subsidiary in place which grants the so-called "exemption privilege for inter-company dividends" (exemption from German income tax of inter-company dividends) - first preliminary question and those in which the double tax treaty does not provide for such an exemption clause - second preliminary question.

The questions asked by the Tax Court in relation to the corporate income tax treatment cover situations in which the permanent establishment received the foreign dividends through the intermediary of a resident subsidiary. For these situations it has further to be ascertained whether there was an agreement on tax integration with the subsidiary in place. Although the questions referred to the ECJ do not expressly refer to the situation of tax integration, it is mentioned in the statement of facts submitted to the ECJ in the court order. Apparently the Tax Court is of the opinion that, if the denial of the treatment requested by the plaintiff infringes the freedom of establishment in Article 52 of the EEC Treaty in case of a direct share holding, the interposing of a domestic subsidiary as a dominated entity in a tax integration (*Organschaft*) would not alter those legal findings.

1. First question referred to the ECJ: Exemption privilege for foreign inter-company dividends under German tax treaties

In order to analyse the tax discrimination with respect to the exemption privilege for inter-company dividends under a German double taxation treaty, three different situations can be distinguished, two of which are the direct subject matter of the questions submitted to the ECJ.

(a) *First situation: German permanent establishment directly holds the shares in the foreign subsidiary*

The first situation concerns the dividends paid by the US subsidiary to the German permanent establishment. If the French company had had a subsidiary resident in Germany (instead of a permanent establishment), the dividends would have been exempted from German corporate income tax under the DTC Germany-USA 1954/65.[9]

The potential tax discrimination in the first situation is, however, only relevant for taxable years before 1994. Germany has eliminated the different tax treatment between German resident companies and German permanent establishments in this situation by unilaterally extending the exemption privilege for inter-company dividends according to a tax treaty to German permanent establishments of foreign corporations. If the exemption privilege for inter-company dividends under a tax treaty is applicable to German resident companies a permanent establishment may benefit from that privilege provided that the permanent establishment holds a direct participation in the foreign subsidiary of at least 10 %.[10] According to the legislative reasoning for the introduction of this provision, which was also quoted by the Tax Court of Cologne in its court order, its purpose was also "to comply with the freedom of establishment under Article 52 of the EEC Treaty and to exclude a prohibited discrimination thereunder".[11]

Although the legislator admitted that there was an unlawful discrimination of permanent establishments, the new provision has no retroactive effect and is not applicable prior to 1994. However, the plaintiff can directly invoke the freedom of establishment under Article 52 of the EEC Treaty, since Article 52 of the EEC Treaty is, according to established case-law, as of the expiration of the so-called transitional period, directly applicable law in all Member Sates.[12]

(b) *Second situation: German permanent establishment indirectly holds the shares in the foreign subsidiary through a German subsidiary (no agreement on tax integration in place)*

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9 Article XV (1) (b) no. 1, Article II (1) (f) of the Convention between the Federal Republic of Germany and the United States of America for Avoidance of the Double Taxation with respect to Taxes on Income and certain other Taxes of 22nd July 1954 in the version of the Protocol of 17th September 1965 ("DTC Germany-USA") applicable to the year 1988. It has to be noted that the DTC requires a minimum participation in the voting shares of at least 25%. However, Germany unilaterally reduced and reduces the requirement of a minimum participation in the voting shares under tax treaties to at least 10 %; § 26 (7) KStG in the then applicable version of the law; now § 8b (5) KStG.

10 § 8b (4) KStG which was introduced in the course of the "Tax Act for Improving Germany as an Investment Location" of 13th September 1993, *Standortsicherungsgesetz*. For further details see Blumenberg, Recent Developments in German International Taxation, in: *The International Tax Journal,* Vol. 20 No. 3 1994, p. 68.

11 Federal Council (*Bundesrat*) Publication 1/93, p. 40.

12 ECJ judgment *avoir fiscal*,[1986] ECR, 273 at para. 13.

In this second situation, the German permanent establishment indirectly holds the shares in the foreign subsidiary via a German intermediate holding company. There exists no agreement on integration for German tax purposes (no *Organschaft*) between the permanent establishment and the intermediate German holding company. The intermediate German company would receive dividends from the foreign subsidiary (second tier subsidiary of the German permanent establishment) and then redistribute the dividends to the permanent establishment.

Since this situation did not exist in the case at issue, the question of the compatibility of the German tax treatment in the second situation with EC law was not referred to the ECJ. However, this situation serves to demonstrate the unequal treatment of dividends under German tax law and provides for a systematic link to the third situation.

The German tax treatment of this second situation is as follows: the dividends received by the German intermediate holding company from its foreign subsidiary would be exempt from German corporate income tax under an applicable German tax treaty (such as the German tax treaties with the US and Switzerland). Upon redistribution of the foreign dividends by the German intermediate company to a 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. The amendments introduced in 1993 to the KStG did not alter the tax treatment at the level of the permanent establishment because the inter-company exemption privilege on the (re-) distribution of foreign dividends[13] under German domestic law applies only if the recipient is a German resident corporation but not if the recipient is a non-resident corporation such as a permanent establishment of a foreign company.[14]

Although this situation is not an issue of the preliminary ruling, it seems rather obvious that, if the tax treatment in the first situation constitutes an infringement of Articles 52, 58 EEC Treaty, the German tax treatment in the second situation is also discriminatory. 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 the second situation, the exemption would be denied for the sole reason that the recipient is a non-resident taxpayer. Irrespective of whether this situation is at issue in the *Saint-Gobain* case, the ECJ's judgment on the questions relating to the first (and the third) situation should also clarify the compatibility of the German tax treatment in the second situation with EC law.

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13 So-called "EK-01 dividends".

14 No application of § 8b (1) and (4) KStG; see note 10 above.

(c) *Third situation: German permanent establishment indirectly holds the shares in the foreign subsidiary through a German subsidiary with which an agreement on tax integration is in place*

This situation refers to the indirect participation in the Swiss subsidiary which is held through the intermediary of a German resident subsidiary with which an agreement on tax integration (*Organschaft*) is in place. Due to the existence of this agreement on integration for German tax purposes, the income received by the intermediate German holding company (the dominated entity), including the dividends received from Switzerland, is attributed to the German permanent establishment as the dominating entity. Absent an agreement on tax integration, the dividends received by the intermediate German holding company would have been tax-exempt at the level of the German holding company under Article 24 (1) no. 1 (b) of the then applicable version of the tax treaty between Germany and Switzerland. However, in case of a "tax integration relationship", German domestic law provides that the exemption privilege for inter-company dividends under a tax treaty applies only "if the dominating entity belongs to the taxpayers entitled to the treaty benefits according to the treaty's provisions" (§ 15 no. 2 KStG). Since the dominating entity was a non-resident company, the exemption privilege under the tax treaty was denied.[15]

Unlike the discrimination in the first situation, which was eliminated by the German legislator for taxable years as of 1994 (see above), the discrimination in the third situation continues to exist, because the respective provision in § 15 no. 2 KStG was not amended.[16] Therefore, the judgment of the ECJ will have a direct impact on the future taxation of inter-company dividends in this third situation.

2. Second question referred to the ECJ: Indirect foreign tax credit

The second question submitted to the ECJ refers to the eligibility of the German permanent establishment to the indirect foreign tax credit in respect of dividends which the permanent establishment received from first and second tier foreign subsidiaries. While German tax treaties mostly provide for the tax exemption of dividends from qualifying foreign subsidiaries as the measure to provide relief from double taxation

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15 This result is somewhat strange because the purpose of the denial of treaty benefits in case of an "Organschaft" is to ensure that the exemption privilege should not be (indirectly) granted to individuals; here, the dominating entity is a permanent establishment of a *company* resident in another EC Member Sate.

16 However, one might argue that, for taxable years as of 1994, the permanent establishment, although not being entitled to tax benefits directly under a tax treaty, is entitled to the same benefits under § 8b (4) KStG in conjunction with the tax treaty.

(exemption method), the tax credit method (indirect foreign tax credit) is generally applied to inter-company dividends absent a tax treaty and in cases where the tax treaty does not provide for an exemption of foreign inter-company dividends. For Example (The tax treaties concluded between Germany and Austria and between Germany and Italy, in the version applicable for the taxable year 1988, did not provide for an exemption of foreign inter-company dividends.)

For an analysis of the tax discrimination against permanent establishments with respect to the denial of the indirect foreign tax credit, again three different situations must be distinguished.

(a) First situation: German permanent establishment directly holds the shares in the foreign subsidiary

The denial of the granting of the indirect foreign tax credit in the first situation (German permanent establishment directly holds the shares in the foreign subsidiary) is not an issue of the *Saint-Gobain* case. However, the question of the compatibility with EC law of the German tax treatment in this first situation was referred to the ECJ because of the existence of the integration agreement for German tax purposes (see (c) below).

Under the rules for the indirect foreign tax credit contained in German domestic tax law, a German resident corporation holding a participation of at least 10 % in the nominal capital of an active foreign subsidiary may, under certain further conditions, credit the foreign corporate income tax underlying dividends from the foreign subsidiary against its corporate income tax (§ 26 (2) KStG). In the year 1988, relief from double taxation for inter-company dividends from subsidiaries located inter alia in Austria and Italy was avoided by application of the tax credit method, which in turn was denied to a German permanent establishment because it was a non-resident taxpayer.

Like the different tax treatment of permanent establishments with respect to the exemption privilege under a tax treaty, Germany has eliminated any difference between the treatment of permanent establishments and the treatment of German resident corporations with respect to the indirect foreign tax credit for the taxable years as of 1994 (§ 26 (7) KStG). The official explanation for the introduction of the elimination of this discrimination was the same as the one for the introduction of the exemption privilege for inter-company dividends in a tax treaty situation, i.e. Germany was aware of the discrimination issue.

(b) Second situation: German permanent establishment indirectly holds the shares in the foreign subsidiary through a German subsidiary (no agreement on tax integration in place)

The discrimination of a German permanent establishment as compared to a German resident corporation regarding the denial of the indirect foreign tax credit in the second situation is basically the same as in the case where a tax treaty is in place[17]. The discrimination against permanent establishments in this situation was not disputed in the case at issue and, therefore, not explicitly referred to the ECJ. However, it can be expected that the reasoning of the ECJ concerning the first situation will clarify whether the tax discrimination against a permanent establishment in the second situation, which does still exist, constitutes an infringement of Article 52, 58 EEC Treaty.

(c) Third situation: German permanent establishment indirectly holds the shares in the foreign subsidiary through a German subsidiary with which a valid agreement on tax integration is in place

This situation refers to the dividends which the German permanent establishment received from its indirect subsidiaries in Austria and Italy; the participations were held through an intermediate German holding company with which an agreement on tax integration was in place. The indirect foreign tax credit was not granted to the German permanent establishment for these dividends because the permanent establishment was not a resident company; otherwise, the requirements for the German indirect foreign tax credit have been fulfilled.

As in the first situation, the question of tax discrimination is only relevant for taxable years before 1994 because Germany has eliminated this treatment of permanent establishments for taxable years as of 1994.[18]

3. Third question referred to the ECJ: Exemption privilege for purposes of German net worth tax

The third question referred to the ECJ for a preliminary ruling deals with the exemption from German net worth tax (*Vermögensteuer*)in respect of a direct participation in a foreign company (§ 102 (2) BewG). In the case referred to the ECJ, the exemption privilege for net worth tax purposes for the shares in the US company was denied on the sole basis that the participation was held by a non-resident taxpayer (the German

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17 See page 40 above at III.1.b.

18 § 26 (7), (2), 19 (1) KStG; sec. 65 (1) Corporate Income Tax Regulations, *Körperschaftsteuer-Richtlinien*/"*KStR*".

permanent establishment of the French company) and not by a German resident corporation.

Subsequent to a decision of the German Constitutional Court, net worth tax is no longer levied as from 1st January 1997.[19] Due to this (de facto) abolition of German net worth tax, the ECJ's answer to this question will have a direct relevance only for the past, i.e. to the extent that this issue has been relevant and the statute of limitation for the tax assessments has not yet expired. Foreign corporations concerned can benefit, though, from a positive answer of the ECJ and should appeal against their tax assessments. However, German net worth tax was not formally abolished and after the elections in September 1998 the German legislator will consider to re-introducing a net worth tax. Therefore the ECJ's answer to the third question may be of relevance for the future.

IV Discrimination of peranent establishments under Community law

In its order, the Tax Court of Cologne stated that the decisive factor underlying its decision to refer the questions to the ECJ for a preliminary ruling was that the denial of all tax benefits claimed by the plaintiff had been solely based on the fact that the plaintiff, as the permanent establishment of a French corporation, was a non-resident taxpayer. All other conditions for receiving the claimed tax benefits had been fulfilled.

The Tax Court of Cologne explicitly referred to the ECJ decisions in the *avoir fiscal*[20] and *Commerzbank*[21] cases in which the ECJ held that, if it were permissable for a Member State to extend, at its discretion, an unequal treatment to a branch merely because the company has its seat in another Member State, the freedom of establishment under Articles 52, 58 EEC Treaty would be eroded.

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19 On 22nd June 1995 the German Constitutional Court held (case no. 2 BvL 37/91) that the net worth tax was in part unconstitutional because real estate was assessed with the values as at 1964/67 whereas other assets subject to net worth tax were assessed by reference to current values which resulted in a considerably more favourable tax treatment of real estate compared to other assets, in particular capital assets. The Court further held that the unconstitutional provisions were still applicable until 31st December 1996. Since the legislator did not amend the net worth provisions before 31st December 1996 net worth tax is not to be levied as of 1st January 1997.

20 ECJ judgment of 21st January 1986, case 270-83, *avoir fiscal*, 1986 ECR [1986] 273.

21 ECJ judgment of 13th July 1993, case C-330/91, *Commerzbank*, 1993 ECR [1993] I-401.

1. Jurisprudence of the ECJ

According to the jurisprudence of the ECJ,[22] Article 52 of the EC Treaty embodies one of the fundamental principles of the Community and has been directly applicable in the Member States since the end of the transitional period.[23]

The freedom of establishment for nationals of one Member State on the territory of another 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 the nationals 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 any other Member State. Article 52 is thus intended to ensure that all nationals of Member States who establish themselves in another Member State, even if that establishment is only secondary, for the purpose of pursuing activities there as self-employed persons, receive the same treatment as nationals of that State and it prohibits, as a restriction on freedom of establishment, any discrimination on grounds of nationality resulting from the legislation of the Member State.

Discrimination arises through the application of different rules to comparable situations or the application of the same rule to different situations.[24] The rules regarding equality of treatment forbid not only overt discrimination by reason of nationality but all covert forms of discrimination which, by the application of other criteria of differentiation, lead in fact to the same result.[25] Traditionally, and in general, tax law does not apply the criterion of nationality but the criterion of fiscal residence within national territory. The use of this criterion, although applied independently of the nationality of the taxpayer, is liable to work more particularly to the disadvantage of companies having their seat in another Member State. In the case of companies it is their seat (registered office) that serves as the connecting factor with the legal system of a particular State, like nationality in the case of natural persons. Therefore, in the case of companies their

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22 ECJ judgment *avoir fiscal*, 1986 ECR [1986] 273 at para. 13.

23 The transitional period expired on 31st December 1969, cf. Article 7 and 247 of the EC Treaty.

24 ECJ judgment of 11th August 1995, case 80/94, *Wielockx*, 1995 ECR [1995] I-2655 at para. 17; ECJ judgment of 27th June 1996, case C-107/94, *Asscher*, 1996 ECR [1996] 3089 at para. 40.

25 ECJ judgment of 13th February 1974, case 152/73, *Sotgiu*, 1974 ECR [1974] 153, at para. 11; ECJ judgment *Commerzbank*, 1993 ECR [1993] I-4017, at para. 14; ECJ judgment *Halliburton*, 1994 ECR [1994] I-1137, at para. 15.

seat is the significant criterion in determining whether an overt or a covert discrimination in the sense of Article 52 of the EEC Treaty arises.[26]

According to the jurisprudence of the ECJ the difference in treatment of resident companies and permanent establishments cannot be justified by any advantages which permanent establishments may enjoy vis-à-vis resident companies. Since "Article 52 prohibits all discrimination, even if only of limited nature."[27] Therefore, the rules regarding equality of treatment forbid also a compensation of disadvantages with advantages.

2. Discrimination in the *Saint-Gobain* case

In the *Saint-Gobain* case, the tax treatment of German permanent establishments of foreign EC-resident corporations as compared to German resident corporations constitutes a discrimination through the application of different rules to comparable situations.

(a) Unequal treatment

German permanent establishments of foreign EC-resident corporations and German resident corporations are to a large extent treated in the same way; however, German tax law differentiates between them with respect to participations in foreign subsidiaries. Germany grants an exemption or an indirect tax credit for foreign inter-company dividends to resident corporations but not to German permanent establishments of foreign EC-resident corporations. This unequal treatment entails discrimination in form of the application of different tax rules in relation to income from foreign subsidiaries and to the participation in the foreign subsidiaries.

In the written observations submitted to the ECJ in the *Saint-Gobain* proceedings it has been argued that the ECJ has ruled[28] that, in relation to direct taxes, the situations of residents and of non-residents are, as a rule, not comparable. However, the ECJ has expressed this general rule only for the tax treatment of natural persons, because their personal ability to pay tax, determined by reference to their aggregate income and their

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26 ECJ judgment *Commerzbank*, 1993 ECR [1993] I-4017, at para. 14; ECJ judgment *Halliburton*, 1994 ECR [1994] 1139, at para. 15.

27 ECJ judgment *avoir fiscal*, 1986 ECR [1986] 273 at para. 21; ECJ judgment *Commerzbank*, 1993 ECR [1993] I-4017, at para. 19.

28 ECJ judgment of 14th February 1995, case C-279/93, *Schumacker, 1995* ECR [1995] I-225, at para. 31.

personal and family circumstances, is more easy to assess in the place where personal and financial interests are centred, i.e. the place of residence.[29] For corporations (residents or non-residents) the ability to pay tax is not determined by personal and family circumstances. Therefore the cited general rule of the ECJ is not applicable when comparing the tax treatment of resident and non-resident corporations.

In the written observations it has further been argued that a reason for the unequal treatment of German resident corporations compared with permanent establishments is the different legal nature and the different scope of taxable income. Whereas under German tax rules resident corporations are taxable on their world-wide income, permanent establishments are only taxable on their domestic income. This, however, is only true at a preliminary level. The principle of the taxation of the world-wide income of resident corporations is, with respect to foreign income, to a large extent restricted by tax treaties. Against that, "domestic income" from business activities of a permanent establishment is interpreted in an extensive manner, e.g. it includes foreign inter-company dividends, as in the *Saint-Gobain* case, but interest received from foreign debtors and royalties received from foreign licensees also constitute taxable "domestic income". Due to that extensive interpretation of "domestic income" the taxation of a permanent establishment is close to the taxation of a resident corporation the taxable world-wide income of which is limited by tax treaties.

With respect to the legal nature of taxpayers, the ECJ has not accepted[30] that the difference between a resident corporation and a permanent establishment constitutes a legitimate reason for an unequal treatment. With respect to Article 52 of the EC Treaty, the ECJ has further stated that the registered office of a company "serves as the connecting factor with the legal system of a particular State, like nationality in the case of natural persons. Acceptance of the position 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 the registered office is situated in another Member State would deprive that provision of all meaning."[31]

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29 ECJ judgment *Schumacker,* ECR 1995, p. I-225, at para. 32; ECJ judgment *Wielockx*, ECR 1995, p. I-2655 at para. 18; ECJ judgment *Asscher*, ECR 1996, p. 3089 at para. 41.

30 In particular judgments *avoir fiscal*, *Commerzbank,* and judgment of 15th May 1997, case C-250/95, *Futura Singer*, ECR 1997, p. I-2471.

31 Judgment *avoir fiscal*, at para. 18, judgemt *Commerzbank,* at para. 13.

(b) No justification

The discriminatory tax treatment of a permanent establishment with respect to foreign inter-company dividends is not justified.

The fact that the laws of the Member States on corporation tax have not been harmonised cannot justify the difference of treatment. In this respect the ECJ has said:

> "Although it is true that in the absence of such harmonisation, a company's tax position depends on the national law applied to it, Article 52 of the EEC Treaty prohibits the Member States from laying down in their laws conditions for the pursuit of activities by persons exercising their right of establishment which differ from those laid down for its own nationals.[32]

It has been suggested[33] that Germany should be obliged to give to a permanent establishment any tax relief that it gives to a resident under internal law and therefore one should distinguish between the indirect foreign tax credit issue and the exemption for inter-company dividends; since the indirect foreign tax credit is granted by Germany under internal law it should be applied in taxing a permanent establishment in Germany; the tax exemption for inter-company dividends, however, given by Germany only under tax treaties should, according to this approach, not be given to a permanent establishment in Germany as a result of the EC Treaty. First, in German law tax treaties being conventions concluded between States are not directly applicable, they need to be transposed by an implementing act in which the German legislator approves the convention. Once given force by parliamentary act, tax treaties constitute internal German law of equal status to other statutory tax law. Second, the argument that the difference of treatment is due to the double taxation agreements cannot justify the discrimination. The ECJ has held that "the rights conferred by Article 52 of the Treaty are unconditional and a Member State cannot make respect for them subject to the contents of an agreement concluded with another Member State. In particular, that article does not permit those rights to be made subject to a condition of reciprocity imposed for the purpose of obtaining corresponding advantages in other Member States."[34]

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32 Judgment *avoir fiscal*, at para. 24.

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

34 Judgment *avoir fiscal*, at para. 26.

V Potential judgment by the ECJ and its impacts

Of course, it is always difficult to predict a court's decision. However, taking into account the jurisprudence of the ECJ in matters of direct taxation and, in particular, the judgments on the taxation of permanent establishments, it does not seem unlikely that the preliminary ruling of the Court will be in favour of the plaintiff.

In case the ECJ rules in favour of the plaintiff, the ECJ in its judgment will not declare that the respective provisions of German tax law are incompatible with Community law or even repeal the respective provisions of domestic law. The ECJ will only rule on the interpretation of Community law, i.e. in the case at issue, particularly Articles 52, 58 EC Treaty, with regard to domestic law. If the domestic law is inconsistent with Community law, the domestic law will cease to be applicable.

From a formal point of view, judgments given by the ECJ are only binding on the court submitting the questions for a preliminary ruling and the higher courts deciding the same legal case. However, as a practical matter, the ECJ's judgment will have the same legal effect in all cases concerning the same issue. Therefore, corporations resident in EC Member States outside Germany, which maintain permanent establishments in Germany, should check whether they are affected by the submission to the ECJ. If so, they should appeal against their respective tax assessments.

If Germany, as a consequence of the ECJ judgment in the *Saint-Gobain* case must change the relevant provisions of domestic law, the question will arise as to whether the new (extended) provisions will apply only to German permanent establishments of foreign corporations resident in other EC and EEA countries, or will also apply to German permanent establishments of corporations located in non-EC/non-EEA countries. After the ECJ decision in the *Schumacker* case[35], Germany changed its tax rules only with respect to nationals resident in EC and EEA countries. On the other hand, no distinction was made between German permanent establishments of companies located in EC Member States and German permanent establishments of companies located in non-EC Member States when Germany introduced the exemption privilege for inter-company dividends for German permanent establishments of foreign corporations in case of a direct participation[36] and, likewise, extended the provisions on the indirect foreign tax credit.[37] If Germany extended the exemption privilege for inter-company dividends in the case of an indirect participation in a foreign subsidiary to

35 ECJ judgment of 14th February 1995, case C-279/93, *Schumacker,* 1995 ECR [1995] I-225.

36 § 8b (4) KStG.

37 § 26 (7) KStG.

German permanent establishments of non-EC resident corporations, the use of a German permanent establishment (together with an intermediate German subsidiary) as a holding vehicle for Europe could become attractive.

As a result of the tax court's submission to the ECJ, and maybe even more so following the judgment of the ECJ, the issue of discrimination in the area of taxation of permanent establishments will gain more importance. The discrimination alleged in the *Saint-Gobain* case is not the only difference between the tax treatment of German resident and non-resident companies. A rather well-known example of different tax rules for resident and non-resident corporations concerns the higher corporate income tax rate imposed upon German permanent establishments of non-resident corporations and non-resident partners in a German partnership as compared to the tax rate imposed upon German resident companies (subsidiaries).[38] Presently, permanent establishments of non-resident corporations are subject to a flat corporate income tax rate of 42% com pared to a split-rate for resident corporations of 30% for distributed profits (plus dividend withholding tax, if any[39]) and 45% for undistributed profits. However, during the year at issue in *Saint-Gobain* (1988) there was no tax rate discrimination against German permanent establishments of non-resident corporations.[40]

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. As in many Member States the issue of tax discrimination in Germany is far from fully resolved.

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

39 Effective mid-1996, no dividend withholding tax is levied on dividends paid by a German subsidiary to its qualifying EC parent company under the Parent/Subsidiary Directive.

40 See Rädler/Lausterer, *Der Betrieb* 1993, p. 451, 454.