
Chapter 4

Taxation of Resident Companies on Foreign Business Income Earned through Permanent Establishments

4.1. Introduction

The previous chapter studied how the objective of achievement of the internal market affects the right of Member States to rely on the principle of worldwide taxation and the fiscal principle of territoriality in relation to foreign group companies' foreign profits and losses. Chap. 3 focused on business income incurred by the foreign company itself, whether it was positive or negative income. Chap. 4, by contrast, focuses on income incurred by a resident company in relation to the business it carries on in other Member States through permanent establishments. As in the previous chapter, both the principle of worldwide taxation and the fiscal principle of territoriality raise compatibility issues with the objective of achievement of the internal market with regard to foreign profits and losses. However, although the issues analysed in this chapter may, from the point of view of principle, be comparable to those discussed in the previous chapter, an important difference exists between foreign subsidiaries (studied in Chap. 3) and permanent establishments (studied in Chap. 4): foreign subsidiaries are legal entities and subject to the principle of personality, while permanent establishments are not legal entities on their own. As a result, contrary to the situations described in Chap. 3, the state of residence of a company often takes into account for tax purposes foreign business income incurred through permanent establishments. In such a case, the state of residence makes use of the principle of worldwide taxation. The state of residence may also favour the fiscal principle of territoriality, thereby not taking into account foreign income, whether positive or negative. A combination of both principles is found in certain tax systems, e.g. when foreign positive business income is exempted while losses are deducted upon a later recapture.⁴²⁷ Consequently, the legal analysis conducted on the conflict between Member States' rules on the taxation of companies' foreign business income and the objective of achievement of the internal market

427. An example is provided by Art. 209 C of the French *Code général des impôts*. This article, which applies only to small and medium-sized enterprises, provides relief for losses incurred by foreign subsidiaries held to 95% or more and permanent establishments. Losses have to be recaptured at the latest 5 years after their deduction from the French tax base. Guidelines on the application of Art. 209 C were issued by the French Ministry of Finance on 20 January 2010 (reference 4 H-4-10).

has to take into account this fundamental difference between the taxation of groups of companies and the taxation of single companies because international tax practice largely reflects this legal difference.

In contrast to what was discussed in Chap. 3, there can be no doubt from an international law perspective on the right of a state of residence to apply either taxation principle. Indeed, residence is a strong territorial connection between a state and a tax subject. It is often with its state of residence that a taxpayer has the closest connection. The taxpayer's ability to pay is likely to be the greatest in the state of residence, since worldwide profits and losses are often compiled in the resident's tax base. Offsetting worldwide negative income against worldwide positive income – i.e. computing the worldwide tax base according to the net taxation principle – reveals the actual income and the ability to pay of a resident. It is also in the state of residence that a taxpayer is likely to benefit most from public resources, thus creating a need for fiscal revenues. As a consequence, it is widely accepted that taxpayers are subject to unlimited tax liability in their state of residence.⁴²⁸ Indeed, as discussed in Chap. 2, there is no obligation under international law to limit tax jurisdiction to source income. Nevertheless, the extent of the state of residence's tax jurisdiction is a decision that traditionally lies within its sovereignty: a sovereign state may decide to limit its tax jurisdiction and exempt all or part of a resident's foreign income.

The ECJ, referring to “international tax law” and the OECD Model Tax Convention, has accepted residence as a connecting factor for the levy of taxes on a resident's worldwide income.⁴²⁹ However, conflicts with EU law may arise either way, i.e. whether the Member State of residence applies

428. A few states, however, consider that international law limits tax jurisdiction to source income, irrespective of whether the tax subject is resident or not. See above at 2.3.1.2.

429. See ECJ, 14 February 1995, Case C-279/93, *Finanzamt Köln-Alstadt v Roland Schumacker*, Para. 32: “[I]nternational tax law, and in particular the Model Double Taxation Treaty of the Organization for Economic Cooperation and Development (OECD), recognizes that in principle the overall taxation of taxpayers, taking account of their personal and family circumstances, is a matter for the state of residence.” See also ECJ, 14 September 1999, Case C-391/97, *Gschwind*, Para. 24: “[R]esidence is the connecting factor on which international tax law, in particular the Model Double-Taxation Convention of the Organisation for Economic Cooperation and Development (OECD), is normally founded in order to allocate powers of taxation between States in situations involving extraneous elements.” See also ECJ, 13 December 2005, Case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)* Para. 39: “[B]y taxing resident companies on their worldwide profits and non-resident companies solely on the profits from their activities in that State, the parent company's Member State is acting in accordance with the principle of territoriality enshrined in international tax law and recognised by Community law.”

the principle of worldwide taxation or the fiscal principle of territoriality. Accordingly, compatibility issues are discussed with regard to the application of the principle of worldwide taxation and the taxation of permanent establishments (4.2.), as well as with regard to the application of the fiscal principle of territoriality and the exemption of permanent establishments (4.3.). In addition, a brief overview of the possible requirement of the most favoured nation treatment is provided, since such a requirement could significantly influence the taxation of the foreign business income of companies (4.4.).

4.2. Application of the principle of worldwide taxation in the Member State of residence

“[T]he credit method hampers investment, the provision of services and the taking up of employment in the other EU Members States, and there is no legal justification recognizable for these impediments.”⁴³⁰

“[P]rinciples of Community law do not appear to be obviously contradictory to the taxation of worldwide income.”⁴³¹

4.2.1. Introduction

The taxation of the foreign business income of companies earned directly in other Member States through permanent establishments is an important issue from a tax policy perspective. Indeed, the extent of the tax jurisdiction exercised by the Member State of residence is likely to have significant consequences on the actual exercise of the freedom of establishment, something that ultimately influences the achievement of the internal market. In that respect, the principle of worldwide taxation (often implemented through the credit method) and the fiscal principle of territoriality (often implemented through the exemption method) have opposite characteristics, and accordingly imply opposite consequences on the achievement of the internal market. Therefore, since these two principles are inherently opposed to each other, it is important to identify the taxation principle that should be favoured by the Member States so as to enhance the achieve-

430. Vogel, Klaus, “Which method should the European Community adopt for the avoidance of double taxation?”, *Bulletin for International Fiscal Documentation* (January 2002) p. 10.

431. Lang, “CFC legislation and Community law”, *op. cit.*, p. 377.

ment of the internal market. If no clear preference for either taxation principle can be deduced from ECJ case law, the study of the points of tension between these principles of taxation and the objective of achievement of the internal market is likely to provide some elements of response to the question of which principle of taxation should be favoured.

The taxation of resident companies on a worldwide basis is a developed practice among Member States. Art. 7(1)⁴³² of the OECD Model Tax Convention reflects the broad compromise according to which the state of residence has tax jurisdiction over the worldwide income of resident companies.⁴³³ Worldwide taxation in the state of residence is also implemented by European secondary law for passive income, as the directives applicable in the field of direct taxation favour residence-based taxation over source-based taxation.⁴³⁴

However, even if worldwide taxation of residents is implemented in many domestic laws, tax treaties and European directives, Member States must still enforce the EU Treaties. It should therefore be studied whether the taxation of resident companies on their worldwide income is compatible

432. See Art. 7(1) of the OECD Model Tax Convention, 2010: “Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State.”

433. See also Para. 19 of the introduction to the OECD Model Tax Convention, 2010, where it is indicated that “As a rule, this exclusive right to tax is conferred on the State of residence.”

434. The directives adopted in the field of direct taxation tend to favour taxation in the state of residence, although source taxation is not completely eliminated. See Art. 5 of the Parent-Subsidiary Directive (Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States): “Profits which a subsidiary distributes to its parent company shall be exempt from withholding tax.” See Art. 1 of the Interests and Royalties Directive (Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States): “Interest or royalty payments arising in a Member State shall be exempt from any taxes imposed on those payments in that State, whether by deduction at source or by assessment, provided that the beneficial owner of the interest or royalties is a company of another Member State or a permanent establishment situated in another Member State of a company of a Member State.” See Art. 1 of the Savings Directive (Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments): “The ultimate aim of the Directive is to enable savings income in the form of interest payments made in one Member State to beneficial owners who are individuals resident for tax purposes in another Member State to be made subject to effective taxation in accordance with the laws of the latter Member State.”

with the objective of achievement of the internal market. First, it should be observed that the ECJ held, particularly in *Gilly*⁴³⁵ and *Saint-Gobain*,⁴³⁶ that Member States remain sovereign as to the determination of the criteria for the levy of taxes. This view has been repeated in several later cases where the Court considered that Member States may rely on the OECD Model Tax Convention.⁴³⁷

The ECJ answered more precisely to whether or not the taxation of foreign income constitutes, as such, a prohibited discrimination. The Court touched upon this issue in the *Schumacker* case, which related to a natural person. The ECJ held that “international tax law, and in particular the Model Double Taxation Treaty of the Organization for Economic Cooperation and Development (OECD), recognizes that in principle the overall taxation of taxpayers, taking account of their personal and family circumstances, is a matter for the state of residence.”⁴³⁸ Additional guidance may be drawn from the *Futura* case,⁴³⁹ where residents were taxed on their worldwide income and non-residents on their domestic income, which the Court considered “cannot be regarded as entailing any discrimination, overt or covert, prohibited by the Treaty”.⁴⁴⁰ That is, taxation of residents on their worldwide income would be compatible with EU law. This statement was repeated later on⁴⁴¹ until two cases in which the Court dealt specifically with the taxation of head offices with regard to business income earned by their permanent establishments: in *Columbus Container*⁴⁴² (4.2.2.) and

435. ECJ, 12 May 1998, Case C-336/96, *Gilly*. See particularly Paras. 24 and 30.

436. ECJ, 21 September 1999, Case C-307/97, *Saint-Gobain*, Para. 56.

437. See e.g. ECJ, 15 May 2008, Case C-414/06, *Lidl Belgium GmbH & Co. KG v. Finanzamt Heilbronn*, Para. 22.

438. See ECJ, 14 February 1995, Case C-279/93, *Finanzamt Köln-Alstadt v. Roland Schumacker*, Para. 32.

439. However, it should be observed that *Futura* was issued from the perspective of the host state. Accordingly, one can hardly draw far-reaching conclusions from the perspective of the home state on the basis of this case.

440. ECJ, 15 May 1997, Case C-250/95, *Futura Participations SA and Singer v. Administration des contributions*, Para. 22.

441. See particularly ECJ, 13 December 2005, Case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)* Para. 39: “[B]y taxing resident companies on their worldwide profits and non-resident companies solely on the profits from their activities in that State, the parent company’s Member State is acting in accordance with the principle of territoriality enshrined in international tax law and recognised by Community law.” See also Opinion of Advocate General Kokott, delivered on 12 September 2006, Case C-231/05, *Oy AA*, Para. 51. For a comment on the use of the expression “principle of territoriality” with regard to the taxation of residents on their worldwide income in these cases, see Mutén, “Finland may deny deductible group contributions, Advocate General says”, op. cit., pp. 23-24.

442. ECJ, 6 December 2007, Case C-298/05, *Columbus Container Services B.V.B.A. & Co. v. Finanzamt Bielefeld-Innenstadt*. For a comment on this case in relation to

*Krankenheim*⁴⁴³ (4.2.3.), the ECJ ruled on the taxation of foreign partnerships and permanent establishments from the perspective of the state of residence.

Lastly, it is discussed whether EU law may require the grant of a full tax credit, as it may be more favourable than the exemption method or the ordinary credit method if a permanent establishment is situated in a Member State with a higher tax rate than the Member State of residence (4.2.4.).

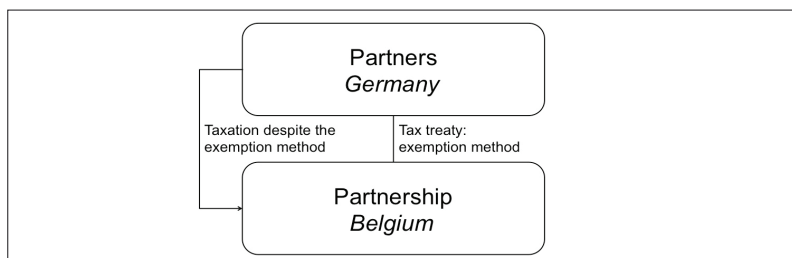
4.2.2. The *Columbus Container* case

Columbus Container is first presented (4.2.2.1.), then discussed (4.2.2.2.).

4.2.2.1. Presentation of *Columbus Container*

In *Columbus Container*, the German partners of a Belgian partnership were taxed on the profits of the partnership, although the applicable tax treaty exempted such income. However, German domestic law switched from the exemption to the credit method when the partnership was taxed at less than 30%.

Figure 8



Member States' sovereignty, see Meussen, Gerard T.K., "*Columbus Container Services* – A victory for the Member States' fiscal autonomy", *European Taxation* (April 2008) pp. 169-173.

443. ECJ, 23 October 2008, Case C-157/07, *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH v. Finanzamt für Körperschaften III in Berlin*. For a comment on this case, see Meussen, Gerard T.K., "The ECJ's judgment in *Krankenheim* – The last piece in the cross-border loss relief puzzle?", *European Taxation* (July 2009) pp. 361-363; Calderón, Jose and Baez, Andrés, "The *Columbus Container Services* ECJ case and its consequences: a lost opportunity to shed light on the scope of the non-discrimination principle", *Intertax* 4 (2009) pp. 212-222.

The question was whether German domestic law, by applying the credit method instead of the exemption method, was in breach of EU law. Despite the less favourable situation created by this switch-over, the German system was accepted by the ECJ. The Court mentioned that “the adverse consequences which might arise from the application of a system for the taxation of profits such as that put in place by the AStG result from the exercise in parallel by two Member States of their fiscal sovereignty”,⁴⁴⁴ referring to *Kerckhaert and Morres*.⁴⁴⁵ It was also recalled that “Member States are at liberty to determine the conditions and the level of taxation for different types of establishments chosen by national companies or partnerships operating abroad, on condition that those companies or partnerships are not treated in a manner that is discriminatory in comparison with comparable national establishments”.⁴⁴⁶ This reasoning indicates that the Court is not willing to disturb the exercise of tax jurisdiction by Member States as long as they do not discriminate between domestic and cross-border situations, which resulted in the acceptance of the principle of worldwide taxation in *Columbus Container*.

4.2.2.2. Discussion of *Columbus Container*

Columbus Container provided a clear answer as to whether or not it is compatible with EU law to tax a permanent establishment or a partnership at the head office level, without, however, discussing the compatibility with EU law of the principle of worldwide taxation as such (4.2.2.2.1.). The solution reached in *Columbus Container* recognizes the taxing rights of Member States beyond the prevention of tax avoidance, which raises compatibility issues with *Cadbury Schweppes* (4.2.2.2.2.). The incompatibility between *Columbus Container* and *Cadbury Schweppes* seems to be explained by the fact that the Court applied a strict discrimination-based analysis, which raises questions as to whether or not the ECJ may also carry out restriction-based analyses (4.2.2.2.3.).

444. ECJ, 6 December 2007, Case C-298/05, *Columbus Container Services B.V.B.A. & Co. v. Finanzamt Bielefeld-Innenstadt*, Para. 43.

445. ECJ, 14 November 2006, Case C-513/04, *Mark Kerckhaert and Bernadette Morres v. Belgische Staat*.

446. ECJ, 6 December 2007, Case C-298/05, *Columbus Container Services B.V.B.A. & Co. v. Finanzamt Bielefeld-Innenstadt*, Para. 53.

4.2.2.2.1. Columbus Container *and compatibility of the principle of worldwide taxation with EU law*

Columbus Container provided the Court an opportunity to indicate whether the principle of worldwide taxation is compatible with the objective of achievement of the internal market. This ruling is of significant importance given the abundant discussions about which principle of taxation best enforces the EU Treaties.⁴⁴⁷ One of the main lessons from the *Columbus Container* case is that the Court considers that the principle of worldwide taxation, applied in a non-discriminatory manner to a foreign transparent partnership or a permanent establishment, is compatible with EU law.

Unfortunately, the ECJ did not analyse the compatibility of the principle of worldwide taxation as such with the objective of achievement of the internal market, although the principle of worldwide taxation raises issues of compatibility with EU law:

- First, the principle of worldwide taxation prevents European companies from structuring their operations so as to enjoy lower foreign tax rates and foreign tax accounting rules, something that is not prevented by the fiscal principle of territoriality. In any case, it can hardly be argued that the principle of worldwide taxation encourages the exercise of the fundamental freedoms as much as the fiscal principle of territoriality, when the business carried on through the permanent establishment is profitable. The very perspective of being taxed up to the level of the home state and according to the tax accounting rules of the home state, as opposed to not being taxed on foreign income, can only hinder a taxpayer from exercising his freedom of movement. In addition,

447. See particularly Vogel, *Taxation of cross-border income, harmonization, and tax neutrality under European Community law, an institutional approach*, op. cit.; Vogel, “Which method should the European Community adopt for the avoidance of double taxation?”, op. cit., pp. 4-10; Kemmeren, *Principle of origin in tax conventions, a rethinking of models*, op. cit.; Kemmeren, “Source of income in globalizing economies: Overview of the issues and a plea for an origin-based approach”, op. cit., pp. 430-452; Wattel, Peter J., “Corporate tax jurisdiction in the EU with respect to branches and subsidiaries; dislocation distinguished from discrimination and disparity; a plea for territoriality”, *EC Tax Review* 4 (2003) pp. 194-202; McLure Jr., Charles E., “The long shadow of history: Sovereignty, tax assignment, legislation, and judicial decisions on corporate income taxes in the US and the EU”, in Avi-Yonah, Reuven S. et al. (eds.), *Comparative fiscal federalism*, Kluwer Law International, 2007, pp. 119-171; Weber, *Is the limitation of tax jurisdiction a restriction of the freedom of movement?*, op. cit., pp. 113-133; Andersson, “An economist’s view on source versus residence taxation – The Lisbon objectives and taxation in the European Union”, op. cit., pp. 395-401; Emonnot, “Intégration financière européenne et fiscalité des revenus du capital”, op. cit.

tion, the ECJ has often repeated that a potential obstacle is sufficient to be in breach of EU law, i.e. no evidence of an actual obstacle has to be brought to identify an infringement to the freedom of establishment.⁴⁴⁸

- Second, the fiscal principle of territoriality puts Member States at competition with each other, which seems in line with Arts. 119 and 120 of TFEU. Indeed, these two articles emphasize the “principle of an open market economy with free competition”. By being taxed at the local rate and according to the tax accounting rules of the host state, permanent establishments may compete with domestic establishments as well as other foreign establishments under similar tax conditions. In *Columbus Container*, until the application of the switch-over from the exemption method to the credit method, the partnership, exempt from taxation in Germany, competed with Belgian companies on rather similar tax conditions. The same tax rate had to be applied locally⁴⁴⁹ and it is most likely that the tax base in the host state was computed according to the tax accounting rules applied to resident companies, given the requirements of the non-discrimination principle. Following the application of the switch-over from the exemption method to the credit method, the partners of the Belgian partnership had to bear a much higher tax burden in their home state, which was not the case for competitors resident in Belgium. Also, the partnership probably had to compute its taxable income according to the tax accounting rules of the home state, which may have been less favourable than those of the host state.⁴⁵⁰ The attractiveness of the state of Belgium, from a corporate income tax perspective, decreased considerably.

Unfortunately, these arguments were not considered by the Court, something that would have been most welcome given the need for guidance as to which principle of taxation should be favoured to implement the internal market.

448. See ECJ, 13 March 2007, Case C-524/04, *Thin Cap Group Litigation*, Para. 62; ECJ, 18 July 2007, Case C-231/05, *Oy AA*, Para. 42; ECJ, 21 January 2010, Case C-311/08, *Société de Gestion Industrielle SA (SGI) v. Belgian state*, Para. 50.

449. As a consequence of the *Royal Bank of Scotland* case, the state of source is not allowed to tax more heavily a permanent establishment than a resident company. See ECJ, 29 April 1999, Case C-311/97, *Royal Bank of Scotland plc v. Elliniko Dimosio (Greek state)*.

450. This may be the case, e.g. if certain costs are deductible in the host state but not in the home state. As a consequence of taxation of worldwide income in the home state, income is usually recomputed according to this state’s tax accounting rules. See Michelsen, “General Report”, op. cit., p. 42.

4.2.2.2.2. Columbus Container *and the prevention of tax avoidance:*
*Can Columbus Container and Cadbury Schweppes be
reconciled?*

Before trying to reconcile *Cadbury Schweppes* and *Columbus Container*, it should first be discussed whether these cases are comparable.

4.2.2.2.2.1. Comparing *Columbus Container* and *Cadbury Schweppes*

Columbus Container shares some similarities with *Cadbury Schweppes*, since in both cases a Member State extended its tax jurisdiction to foreign income to eliminate the advantage resulting from foreign lower tax rates, i.e. the fiscal principle of territoriality was replaced in both cases by the principle of worldwide taxation. The ECJ in *Cadbury Schweppes* came to the conclusion that the UK CFC rules were in breach of the freedom of establishment and could be justified only when they targeted wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned.⁴⁵¹ At first sight, one therefore may feel surprised that the ECJ accepted the German rules at issue in *Columbus Container* without limiting their scope to wholly artificial arrangements, as these rules also replaced the fiscal principle of territoriality by the principle of worldwide taxation. However, three main differences existed between these cases, which may impede their comparability.

First, *Cadbury Schweppes* concerned the taxation of a foreign subsidiary, while *Columbus Container* concerned the taxation of a foreign partnership.⁴⁵² There is a key legal difference between a subsidiary on the one hand and a transparent partnership or a permanent establishment on the other. A transparent partnership or a permanent establishment is often directly taxed in the home state (except in states applying strictly the fiscal principle of territoriality in their domestic law or in tax treaties), while a subsidiary is taxed separately in its own state of residence. Many other differences exist between subsidiaries and permanent establishments or partnerships,⁴⁵³ the point here being only to emphasize that it is legally more far-reaching to apply CFC rules than to tax a transparent partnership or a permanent estab-

451. ECJ, 12 September 2006, Case C-196/04, *Cadbury Schweppes*, Para. 51.

452. The partnership can be assimilated to a permanent establishment for the purpose of this chapter of the dissertation, as the partnership was considered tax transparent in Germany and was taxed as a permanent establishment.

453. For a discussion on the differences between foreign subsidiaries and permanent establishments, see Wattel, "Corporate tax jurisdiction in the EU with respect to branches and subsidiaries; dislocation distinguished from discrimination and disparity; a plea for territoriality", op. cit., pp. 194-202.

lishment, because in the former case the principle of personality has to be set aside.⁴⁵⁴ This argument could partly justify the difference in outcome between *Cadbury Schweppes* and *Columbus Container*, although, as demonstrated in Chap. 2, the consequences of the principle of personality do not result from binding international law.⁴⁵⁵ Also, the ECJ does not pay particular attention to the principle of personality as such, as illustrated by *Marks & Spencer* (with regard to final losses) and *Cadbury Schweppes* (with regard to wholly artificial arrangements). Consequently, the differences between *Cadbury Schweppes* and *Columbus Container* with regard to the principle of personality should not preclude their comparability.

Second, the ECJ found a difference of treatment in *Cadbury Schweppes*, since only parent companies owning shares in certain foreign subsidiaries were subject to CFC taxation, as opposed to parent companies owning shares in domestic subsidiaries. In contrast, no discrimination was at issue in *Columbus Container* because German partnerships were always taxed at the level of their partners: the Belgian partnership, taxed in Germany as a consequence of the switch-over from the exemption to the credit method, was not taxed more heavily than a German partnership. Consequently, the discrimination-based analysis usually carried out by the ECJ inevitably came to the conclusion that the rules at issue in *Columbus Container* were compatible with EU law. However, as discussed in Chap. 3, the discrimination found by the Court in *Cadbury Schweppes* resulted from the restrictive perspective adopted by the ECJ in this case. In particular, had the Court considered that foreign subsidiaries subject to CFC taxation are ultimately taxed in the home state as domestic subsidiaries, the discriminatory treatment was no longer so obvious. Consequently, the actual difference between *Cadbury Schweppes* and *Columbus Container* depends on the perspective according to which these cases are considered.

Third, a tax treaty override⁴⁵⁶ was at issue in *Columbus Container*, as the Belgian partnership was taxed in Germany despite the exemption method chosen in the tax treaty concluded between Belgium and Germany. This tax treaty override may be interpreted as implying that *Columbus Container*

454. For an analysis of the differences of the situations at issue in *Cadbury Schweppes* and *Columbus Container*, see “Opinion statement of the CFE ECJ Task Force on ECJ, *Columbus Container services BVBA & Co v. Finanzamt Bielefeld-Innenstadt*, 6 December 2007, C-298/05 – April 2008”, *European Taxation* (October 2008) pp. 541-544.

455. International law does not require that a foreign subsidiary is taxed to a lower extent than a foreign partnership or a permanent establishment, because no clear limits are set on a state’s tax jurisdiction.

456. On the concept of tax treaty override, see Dahlberg, Mattias, *Svensk skatteavtalspolitik och utländska basbolag*, Iustus Förlag, 2000, pp. 302-313.

goes further than *Cadbury Schweppes*,⁴⁵⁷ i.e. the acceptance of the tax treaty override in *Columbus Container* would be legally more far-reaching than CFC rules such as those at issue in *Cadbury Schweppes*. This could justify different outcomes or even the non-comparability between these cases. However, CFC rules may also be interpreted as resulting in a tax treaty override. Indeed, Art. 7(1) of the OECD Model Tax Convention may be considered as precluding the taxation of foreign companies, unless business is carried on through a permanent establishment in the territory of the taxing state: taxing a foreign subsidiary not having a permanent establishment in the state of the parent company could be precluded by Art. 7(1) of the OECD Model.⁴⁵⁸ Consequently, it could be held that both *Cadbury Schweppes* and *Columbus Container* implied a tax treaty override, although such override was more obvious in the latter case. Additionally, the difference between these cases with regard to their compatibility with tax treaties should not be taken into account by the Court as the purpose of the ECJ is to interpret and implement EU law, not tax treaties. Member States should not have the right to escape their obligations under the EU Treaties through

457. See Pistone, Pasquale, “Ups and downs in the case law of the European Court of Justice and the pendulum of direct taxation”, *Intertax* 4 (2008) pp. 147-148.

458. That was the solution found by the French *Conseil d'Etat* in the *Schneider Electric* case: “*Considérant qu'en vertu du paragraphe 1 du A de l'article 25 de la convention fiscale franco-suisse, dans sa rédaction antérieure à l'avenant du 22 juillet 1997, les revenus visés au 1° de l'article 7 sont exonérés de l'impôt français sur les sociétés lorsqu'ils sont réalisés par une société qui, comme la société Paramer, a en Suisse le siège de sa direction effective et n'a pas d'établissement stable en France; que l'objectif d'élimination des doubles impositions attribué à cette convention fiscale ne saurait justifier une méconnaissance des stipulations susmentionnées au seul motif que l'imposition par la France des bénéficiaires de la société Paramer n'est pas établie au nom de la société suisse mais à celui de sa société mère, qui est une entité juridique distincte et à laquelle lesdits bénéficiaires n'ont pas été effectivement distribués; que, par suite, la cour n'a pas commis d'erreur de droit en jugeant que les stipulations de l'article 7 de la convention fiscale franco-suisse s'opposent à l'application des dispositions de l'article 209 B du code général des impôts*”: see French Supreme Administrative Court (*Conseil d'Etat*), 28 June 2002, No. 232276, *Société Schneider Electric*. For comments see Dibout, Patrick, “L'inapplicabilité de l'article 209 B du CGI face à la convention fiscale franco-suisse du 9 septembre 1966 (À propos de l'arrêt CE, Ass., 28 juin 2002, *Schneider Electric*)”, *Revue de Droit Fiscal* 36 (2002) pp. 1133-1141; Laurent Olléon, “Article 209 B et conventions fiscales internationales: ‘Après les ténèbres, la lumière’”, *Revue de Jurisprudence Fiscale* (October 200), pp. 755-759. It can be observed that Art. 8(1) of the tax treaty concluded between the United Kingdom and Ireland on 2 June 1976 reads exactly the same as Art. 7(1) of the tax treaty concluded between France and Switzerland on 9 September 1966. Therefore, one may find support in the *Schneider Electric* case when arguing that a tax treaty override was also at issue in the *Cadbury Schweppes* case. On the relation between CFC taxation and tax treaties, see Lang, Michael, “CFC regulations and double taxation treaties”, *Bulletin for international fiscal documentation* (February 2003) pp. 51-58; Dahlberg, *Svensk skatteavtalspolitik och utländska basbolag*, op. cit., pp. 314-326.

concluding tax treaties. Consequently, whether or not a treaty override was at issue shall not obstruct the assessment of the compatibility with EU law of the rules at issue in these cases, nor their comparability.

As a result, *Cadbury Schweppes* and *Columbus Container* may be compared to each other, despite the differences discussed above. A comparison evidences an apparent incompatibility between these cases.

4.2.2.2.2. The apparent incompatibility between *Columbus Container* and *Cadbury Schweppes*

The principle of worldwide taxation may be a way of preventing tax avoidance through taxing foreign profits, despite the possible existence of legal barriers such as the incorporation of a foreign subsidiary (CFC rules) or the exemption method in domestic law or a tax treaty. It was argued in Chap. 3 that the freedom of establishment may be abused, in which case a taxpayer may not benefit from the protection of the provisions of the EU Treaties. However, it was also found that as long as a taxpayer exercises his freedom of establishment through a genuine establishment, he should not fear anti-abuse measures.⁴⁵⁹ Consequently, the prevention of tax avoidance should not, in itself, constitute a sufficient argument to generally hinder the exercise of the freedom of establishment. Rather, an extended tax jurisdiction aimed at preventing tax avoidance should act as a corrective mechanism and be applied only when a situation of intolerable abuse has been identified.

In *Columbus Container*, thanks to the exemption method in the Germany–Belgium tax treaty, German taxpayers enjoyed lower tax rates for their investments in Belgian coordination centers than if they had established such activities in Germany. The German taxpayer could also compete on equal footing with Belgian competitors. However, as recalled by the ECJ in *Cadbury Schweppes*, the very fact that a taxpayer structures its operations to benefit from foreign lower tax rates does not, as such, constitute tax avoidance.⁴⁶⁰ a national measure offsetting that advantage should be applicable only if it “specifically relates to wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State

459. See above at 3.2.3.2.

460. ECJ, 12 September 2006, Case C-196/04, *Cadbury Schweppes*, see particularly Para. 49: “[I]t is settled case-law that any advantage resulting from the low taxation to which a subsidiary established in a Member State other than the one in which the parent company was incorporated is subject cannot by itself authorise that Member State to offset that advantage by less favourable tax treatment of the parent company.”

concerned.”⁴⁶¹ As long as a company has an actual establishment in the host Member State and pursues a genuine economic activity there, *Cadbury Schweppes* indicates that a Member State should not offset the advantages of the foreign establishment, even if the taxpayer has a view to minimizing its tax burden.

Given the weight put by the ECJ in *Cadbury Schweppes* with regard to the limited right of a Member State to invoke the prevention of tax avoidance as a justification to offset the advantages of the foreign establishment, and regarding the purpose of the German rules in *Columbus Container*, one may have expected the Court to carry out the same reasoning and consider whether the Belgian establishment constituted a wholly artificial arrangement aimed at circumventing the German legislation. If the ECJ would have reasoned so, it is likely that it would have come to the conclusion that the Belgian partnership had enough substance, as this entity performed “the centralisation of financial transactions and of the accounts, the financing of the liquidity of subsidiaries or branches, the computerisation of data and advertising and marketing activities”.⁴⁶² To perform such functions, the partnership certainly needed “premises, staff and equipment”, which are the criteria used in *Cadbury Schweppes* to consider that a company “physically exists”⁴⁶³ and should not be subject to CFC taxation. Consequently, the partnership was probably not a wholly artificial arrangement, which means that the German rules would most likely not have been justified by the need to prevent tax avoidance, thus being incompatible with EU law.

This conclusion is strengthened by later case law of the Court, which limited the right to justify a tax rule by the need to prevent tax avoidance to situations “involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory”.⁴⁶⁴ The ECJ has indeed observed that “It suffices to note that the tax system at issue in the main proceedings does not specifically aim at such purely artificial arrangements which do not reflect economic reality and are created

461. ECJ, 12 September 2006, Case C-196/04, *Cadbury Schweppes*, Para. 51.

462. ECJ, 6 December 2007, Case C-298/05, *Columbus Container Services B.V.B.A. & Co. v. Finanzamt Bielefeld-Innenstadt*, Para. 15.

463. ECJ, 12 September 2006, Case C-196/04, *Cadbury Schweppes*, Para. 67: “As suggested by the United Kingdom Government and the Commission at the hearing, that finding must be based on objective factors which are ascertainable by third parties with regard, in particular, to the extent to which the CFC physically exists in terms of premises, staff and equipment.”

464. ECJ, 18 June 2009, Case C-303/07, *Aberdeen Property Fininvest Alpha Oy*, Para. 64.

solely with a view to escaping the tax normally due on the profits generated by activities carried out on national territory, and cannot therefore be justified on grounds connected with the prevention of tax avoidance.”⁴⁶⁵ As the German rules did not target wholly artificial arrangements according to this definition but, on the contrary, targeted all establishments subject to a tax rate lower than 30% without taking into consideration the actual substance of such establishments, it is likely that the ECJ would have found the German rules incompatible with EU law.

The UK and German rules at issue in *Cadbury Schweppes* and *Columbus Container* aimed at achieving largely comparable purposes, i.e. depriving a resident taxpayer from the option to locate taxable profits in a low-taxed country that is normally not within the tax jurisdiction of the home state. Both the United Kingdom and Germany qualified such situations as abusive and applied anti-avoidance tax rules that rendered ineffective the structure set up by the taxpayer through replacing the fiscal principle of territoriality by the principle of worldwide taxation. That is, not only the purpose but also the effect of the UK and German rules shared great similarities. That the Court reached so different outcomes in *Cadbury Schweppes* and *Columbus Container* is, from a tax policy perspective, regrettable. It can only be misleading for the Member States as to how to prevent tax avoidance and which principle of taxation should be favoured to levy tax in cross-border situations. By considering the German rules compatible with EU law, the ECJ enhanced the rights of Member States to extend their tax jurisdiction to foreign income as long as they do so in a non-discriminatory manner, without even preventing tax avoidance. Indeed, the reasoning of the Court in *Columbus Container* was totally disconnected from the prevention of tax avoidance, contrary to the Opinion of Advocate General Mengozzi. This confers on *Columbus Container* a very broad scope, which may encourage Member States to extensively apply the principle of worldwide taxation in a non-discriminatory manner.

Still, it cannot be concluded from *Columbus Container* that the Court favours the principle of worldwide taxation over the fiscal principle of territoriality, as confirmed by the *Test Claimants in the CFC and Dividend Group Litigation* case,⁴⁶⁶ issued after *Columbus Container*. Rather, *Columbus Container* illustrates the cautiousness of the ECJ given the political weight of such tax policy issues: the Court seems to refuse to make a choice

465. *Id.*, Para. 65.

466. ECJ, 23 April 2008, Case C-201/05, *Test Claimants in the CFC and Dividend Group Litigation*. This case confirmed that CFC rules are in principle incompatible with EU law.

as to which principle of taxation should be followed. This may explain why the ECJ limits itself to a discrimination-based analysis.

4.2.2.2.3. *Compatibility with EU law of the non-discriminatory taxation of foreign income: Discrimination-based analysis vs restriction-based analysis*

The non-restriction concept is necessary for establishing the internal market, because there are many instances of non-discriminatory measures that do constitute obstacles to the free movement of goods, persons, services and capital.⁴⁶⁷

*[M]ême à défaut d'harmonisation conséquente en cette matière, la Cour est amenée à rappeler aux États membres que, dans l'exercice de leurs compétences fiscales, ils ne peuvent taxer des revenus de manière discriminatoire ou de sorte que leurs propres résidents soient entravés dans l'exercice des libertés de circulation.*⁴⁶⁸

The alternative view is that where cumulative burdens caused by double taxation amount to restrictions that hinder cross-border activity, the Court should apply by analogy its case-law on the fundamental freedoms to eliminate such obstacles. Stripped to its bare essentials, the argument is that any hindrance to the exercise of a fundamental freedom is “a bad thing”. If a true single market is ultimately to be constructed, I can see the force of that argument.⁴⁶⁹

The German rules at issue in *Columbus Container* resulted in applying the same tax treatment to transparent partnerships, whether they were established in Germany or elsewhere. The German rules were not discriminatory and could be considered as a way of implementing capital export neutrality. The Court paid strong attention to the absence of discrimination and found that the German provisions did not infringe the freedom of establishment. By contrast, the ECJ found a difference of treatment in *Cadbury Schweppes* because parent companies were taxed directly on the profits of their foreign but not domestic subsidiaries. Consequently, there was a formal difference of treatment between a domestic and a cross-border situation in *Cadbury Schweppes*, while no such difference existed in *Columbus Container*.

467. Vanistendael, *General report on the fundamental freedoms and national sovereignty in the European Union*, op. cit., p. 173.

468. Lenaerts? Koen, “Dans le prétoire de l’Europe – entretiens avec Vassilios Skouris, Koen Lenaerts, Jean-Claude Bonichot, Philippe Léger, Antonio Tizzano, Hubert Legal et Yves Bot”, *Revue Europe* (April 2007.) p. 7.

469. Opinion of Advocate General Sharpston, delivered on 17 December 2009, Case C-96/08, *CIBA*, Para. 29.

In my view, the discrimination criterion has been overlooked by the ECJ in *Columbus Container*. It is submitted that it is open to criticism that the Court reaches so different solutions from a tax policy point of view solely because it identified a (questionable)⁴⁷⁰ difference of treatment in one case but not in the other. Indeed, and as demonstrated above, the CFC rules at issue in *Cadbury Schweppes* and the switch-over in *Columbus Container* are largely comparable, as they share the same purpose⁴⁷¹ and have similar effects.⁴⁷² The discrepancy between *Cadbury Schweppes* and *Columbus Container* illustrates the limits of the discrimination-based analysis carried out by the ECJ.

If one considers the situation of the taxpayer, it is difficult to state that the German rules did not prohibit, impede or render less attractive the exercise of the freedom of establishment. The switch-over from the exemption method to the credit method increased the tax burden of the taxpayer by 53%,⁴⁷³ and probably created an additional administrative burden.⁴⁷⁴ Advocate General Mengozzi found that the German rules

[M]ight be regarded as having the effect of fragmenting the common market, by encouraging German nationals to establish themselves only in Member States where the level of taxation is equal to or above the German rate provided for in the AStG. Following that line of reasoning, this measure would therefore be likely to deter German nationals from setting up, acquiring or maintaining a permanent establishment in a Member State in which it is subject to a level of taxation below 30%.⁴⁷⁵

Accordingly, AG Mengozzi considered that

[T]he judgment in *Cadbury Schweppes and Cadbury Schweppes Overseas* ... in the light of the Opinion of Advocate General Léger, may be interpreted as meaning that a Member State of residence cannot restrict the freedom of estab-

470. The identification of a difference of treatment in *Cadbury Schweppes* depends on the way one considers the situation at hand in this case: see above at 3.2.2.1.

471. The purpose of these two measures was the elimination of foreign lower tax rates applicable to non-taxable income in the home state.

472. The effect of these two measures was the taxation of foreign income by the home state that is normally outside its tax jurisdiction.

473. See ECJ, 6 December 2007, Case C-298/05, *Columbus Container Services B.V.B.A. & Co. v. Finanzamt Bielefeld-Innenstadt.*, Para. 37.

474. However, such an additional administrative burden is not necessarily incompatible with EU law. See ECJ, 12 December 2006, Case C-446/04, *Test Claimants in the Franked Investment Income Group Litigation v. Commissioners of Inland Revenue*, Para. 53.

475. Opinion of Advocate General Mengozzi, delivered on 29 March 2007, Case C-298/05, *Columbus Container Services B.V.B.A. & Co. v. Finanzamt Bielefeld-Innenstadt*, Para. 132.