

Newsalert

EU Direct Tax Group

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JUDGMENT IN CASE C-253/03 (CLT-UFA): DIFFERENT TAX RATES FOR RESIDENTS AND NON-RESIDENTS

CLT-UFA, a Luxembourg resident corporation, maintained a permanent establishment in Germany in 1994 and was subject to corporation tax in Germany with the income derived from that permanent establishment. The income was assessed with a tax rate of 42 %, applicable at that time to non-resident corporations. CLT-UFA appealed against this and took the case to the German Supreme Tax Court, arguing that the tax rate for non-resident corporations was contrary to the freedom of establishment. The German Supreme Tax Court stated that although a German subsidiary of a non-resident parent was subject to tax rate of 45 % on retained earnings in 1994, this tax rate was reduced to 33.5 % upon distribution to a non-resident parent before June 30, 1996 and thereafter reduced to 30 %. Moreover, the Court emphasised that subsidiaries distributed their profits on a regular basis in order to benefit from the lower distribution rate. The Court held it questionable whether the different tax rates are justified within the meaning of the fundamental freedoms and therefore referred the following questions to the ECJ: Does the freedom of establishment (Art. 43, 48 EC) preclude national legislation stating that income derived in 1994 by a non-resident corporation through a permanent establishment in Germany was taxed with 42 %, where distributed profits of a German subsidiary were charged with German corporation tax (including withholding tax) at a rate of 33.5 % before June 30, 1996 and 30% after June 30, 1996? Secondly, in case this constitutes an infringement of Art. 43, 48 EC, does the tax rate for non-residents corporations have to be reduced to 30%?

In its judgment of February 23, 2006, the ECJ held that Art. 43, 48 EC preclude such legislation as the German.

The ECJ pointed out that the freedom of establishment expressively grants market participants the right to choose an appropriate legal form for their undertakings in other Member States, i.e. companies are allowed to open a branch in another Member State in order to pursue their activities under the same conditions as those which apply to subsidiaries.

The ECJ rejected the tax authorities' and the German government's position that a permanent establishment and a subsidiary are objectively not comparable. In both situations, the profits are at the disposal of the company controlling the subsidiary/permanent establishment. The only difference is that a distribution of profits from a subsidiary presupposes a formal decision whereas the profits of a permanent establishment are part of the assets of the company even in the absence of a formal decision. A parent company can moreover return distributed profits as e.g. equity to the subsidiary, so that there is no justification for the higher tax rate on the profits of a permanent establishment. The ECJ also pointed to the fact that a permanent establishment and a subsidiary are, from a Luxembourg point of view, in the same situation, since both dividends from a German subsidiary as well as profits from a German permanent establishment are tax exempt in Luxembourg. Further, the computation of the tax base is the same for a permanent establishment as for a subsidiary. Under these circumstances, German subsidiaries and German branches of a Luxembourg company are in comparable situations.

The ECJ left it to the referring court to answer the second question, since the ECJ has no jurisdiction to give a ruling on the facts in an individual case and thus could determine if the profits were transferred from the permanent establishment before or after June 30, 1996. However, it instructed the German Supreme Tax Court to apply the same overall tax rate to the income from the permanent establishment that had applied to a distributing subsidiary.

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In the CLT-UFA judgment, the ECJ confirmed the principle of free choice of legal form in the Host State. In this specific case, the ECJ considered a permanent establishment and a hypothetical subsidiary to be comparable. In the Marks & Spencer judgment of December 2005, the ECJ did, however, not pick up the claimant's argument that a foreign subsidiary is comparable to a hypothetical foreign permanent establishment for tax purposes in the State of origin.

For more detailed information, please do not hesitate to contact your local PwC contact person or a member of the EUDTG.

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