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FEATURED PERSPECTIVES

The Egg of *Columbus Container*: German Budget Sunny Side Up, Not Scrambled

by Wolfgang Kessler and Rolf Eicke

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No doubt Christopher Columbus would have felt shortchanged if he knew the continent he discovered does not carry his name. In 1507, when the cartographer Martin Waldseemüller designed his famous world map, he searched for a name for the Terra Nova (New World) and chose America, after the adventurer Amerigo Vespucci from Florence. That map is the birth certificate of the United States of America. The only surviving original is displayed in the Library of Congress in Washington. A couple of months ago the seller revealed that the Library of Congress paid $10 million for it, the highest price ever paid for a cartographic piece of work. The presentation of the map in the Treasures Gallery of the Library of Congress cost another $1.5 million.

When Waldseemüller drafted the second edition of his map, in 1513, he doubted that America was a separate continent and named it Terra Incognita (unknown territory). However, the name ''America'' was already well known enough that the change received little attention.

However, Columbus did manage to attach his name to something. According to legend, a Spanish nobleman told Columbus that if the explorer had not discovered the New World, another adventurer would have. In response, Columbus bet that neither the nobleman nor his companions could make an egg stand on its end. After they had all tried and failed, Columbus tapped the egg gently on the table, breaking it slightly, and stood it on its end, thus demonstrating with the ''Egg of Columbus'' that anyone can perform a difficult feat once they have been shown how, but it takes a genius to discover something new.

More recently, Columbus' name lives on in the European Court of Justice's *Columbus Container* decision (C-298/05). (For the ECJ judgment in *Columbus Container*, see *Doc 2007-26756* or *2007 WTD 236-11*.)

Facts of the Case

The case involved a Belgian limited partnership called Columbus Container Services BVBA & Co., which functioned as a Belgian coordination center. Eight members of a German family who were also partners of one of the largest German partnerships owned the shares of the company. The partnership is invested in the shipping and brewery industries. The business purpose of Columbus Container was to provide finance, management, marketing, and bookkeeping activities of this worldwide operating partnership. However, the main economic activity was holding capital participations. One shareholder represented all family shares of Columbus Container in the shareholders assembly.

Under German international tax law, all partnership profits are deemed to be branch profits of each individual or corporate shareholder for purposes of taxation. German tax treaty policy commonly exempts foreign branch income from German taxation. Therefore, Belgian partnership profits of German partners are taxed only once in Belgium and are exempt branch profits in the eyes of the German tax authorities. The

Photo courtesy of the Geography and Map Collection of the Library of Congress

Martin Waldseemüller's first world map (1507).

branch profits are relevant only for purposes of calculating the tax rate (exemption with progression).

Switch-Over Rule

Because the German controlled foreign corporation rules (sections 7 to 14 Foreign Tax Act or *Aussensteuergesetz*) cover only corporations, branch profits would not be subject to any CFC provisions if there was no section 20(2) Foreign Tax Act, the rule under review. That rule is one of the few switch-over rules in German tax law, providing for a switch-over from the exemption to the credit method if the foreign branch generates income that would be CFC income if the branch was a corporation. The German tax office found that Columbus Container did generate (passive) low-taxed CFC income, and thus it taxed the income and granted a tax credit for the taxes paid in Belgium. Columbus Container appealed and argued that section 20(2) Foreign Tax Act infringes on the European Community freedom of establishment and freedom of capital movement because it makes cross-border establishments less attractive.

New Egg of Columbus?

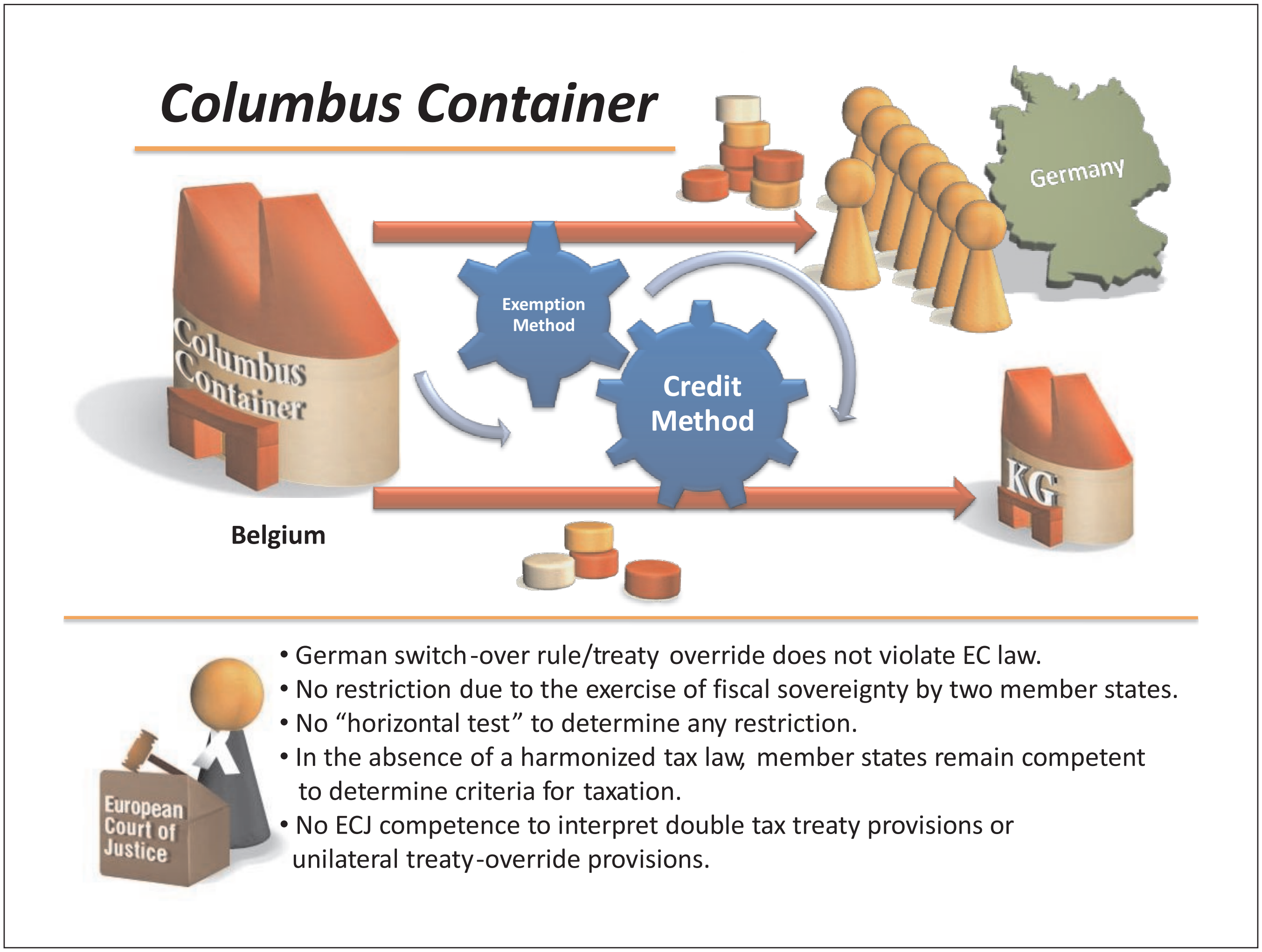
A German tax court referred the case to the European Court of Justice to answer two questions:

- Does section 20(2) Foreign Tax Act restrict Columbus Container's exercise of the freedom of establishment and/or the freedom of capital movement?
- If there was a restriction, is it justified?

The ECJ answered only the first question and found that there was no restriction. If the Court had found that there was a restriction, there would have been good reason to assume that the restriction was not justified:

- first, because there are no grounds for justification if a member state unilaterally eliminates the tax benefits granted by another member state; and
- second, the statutory purpose of the German switch-over rule in section 20(2) Foreign Tax Act is not the targeting of a ''mere artificial arrangement,'' which the ECJ demands to justify a restriction.

The ECJ based the decision on an evaluation of the freedom of establishment, following its case law that this freedom takes priority over the freedom of capital movement if the provision under review has a definite influence on the company's decision. Since all family members pursued the same interests in the case, definite influence existed. Concerning the free movement



of capital, the Court stated only that there was no violation. However, by referring to the freedom of capital movement at the end of the decision, the Court contradicted its own case law, under which the application of the freedom of permanent establishment bars any further references to the freedom of capital movement.

Regarding the freedom of establishment, the ECJ declined a restriction on the basis that the German switch-over rule makes no distinction between income from a domestic partnership and income from a partnership that resides in another member state that subjects the profits made by those partnerships in the given state to a tax rate below 30 percent. The application of the credit method ensures that in both situations the income is taxed at approximately 30 percent. Thereby, the ECJ applies the vertical test (or migrant/nonmigrant test), which determines whether a mere domestic situation is treated differently from a cross-border situation.

The Egg of Columbus illustrates the notion that it takes a genius to discover something new, but once it is demonstrated, everyone can do it. The ECJ did not present an Egg of Columbus, as it repeated only what was said before in its *Kerckhaert-Morres* and *Cadbury-Schweppes* decisions. (For the ECJ judgment in *Kerckhaert-Morres* (C-513/04), see *Doc 2006-23075* or *2006 WTD 220-10*. For the ECJ judgment in *Cadbury Schweppes* (C-196/04), see *Doc 2006-19082* or *2006 WTD 177-8*.)

If the Court had followed the opinion of Advocate General Paolo Mengozzi, there would have been an Egg of Columbus. Mengozzi maintained that there was an unjustified restriction of both the freedom of establishment and the freedom of capital movement. He based his conclusion on the fact that the German switch-over rule treats foreign establishments in two or more EC member states differently, depending on whether the branch is low-taxed. However, like in *Cadbury Schweppes*, the Court in *Columbus Container* declined to apply a horizontal test and instead applied the vertical test (or migrant/nonmigrant test). The horizontal test identifies a restriction by comparing cross-border investments in a given member state with cross-border investments in another member state. Obviously, the judges were aware that the application of the horizontal test would have opened the door to a most-favored-nation treatment.

Lessons Learned

In the field of European Community law, EC tax law doubtless has the highest potential for disputes between the ECJ and the member states. The reason is as simple as it is practical: The power to tax is the power to govern. The member states hold tightly to their competence to tax, because any loss of tax competence means budget and revenue losses. There is the perception among EU member states that the ECJ constituted an enormous risk for the domestic budgets by pushing its competence to the limits. Some authorities even claim that the competence of the ECJ should be restricted. We believe those claims cannot be taken seriously, because they undermine the important purpose the ECJ serves, namely the elimination of unjustified cross-border restrictions in order to realize an internal market. In fact, ECJ decisions that are detrimental to the member states' budgets are often only repercussions of poor (and, regarding EC tax law issues, ignorant) lawmaking in the member states.

No matter who is right or wrong on this issue, *Columbus Container* surely doesn't infringe on any taxation competence of the member states. Instead, the settled case law is some cause for celebration among them, as the Court reiterates that in the absence of harmonized rules, the member states remain competent to determine the criteria for taxation of income and wealth.

However, if the Court had followed the opinion of Mengozzi, it would have opened the door to a most-favored-nation treatment, and the legislatures in the member states would have an issue with the ECJ.

Also, the Court found that no uniform harmonization measures to eliminate double taxation have yet been adopted at the Community law level. Instead, the EC competence to eliminate double taxation relates only to some specific cases (for example, the parent-subsidiary directive and the interest royalty directive eliminating withholding taxes within the European Union).

Also, the Court does not claim jurisdiction to rule on the conformity of a domestic rule with a double tax treaty provision, particularly regarding domestic treaty-override provisions such as the German switch-over rule. Some commentators have criticized the nonintervening approach the ECJ took in *Columbus Container*. However, the critics also concede that *Columbus Container* might have been the wrong case to refer to the ECJ in order to get a ruling on these subjects.

Finally, the case provides no guidance on whether the German CFC rules are in line with EC law. That matter will be addressed in coming cases.

Conclusion

Even though America was not named after Christopher Columbus, a recent ECJ case was, and the story of the Egg of Columbus can be used to describe the outcome of that case. In essence, the ECJ did not discover new principles or create new lines of argumentation in *Columbus Container*. Instead, the Court repeated its case law and refrained from both conflicting with the member states and scrambling the German budget. ◆