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EU COURT OF JUSTICE: NON-DEDUCTIBILITY OF LOSSES OF A FOREIGN PERMANENT ESTABLISHMENT

The Court of Justice of the European Union (hereinafter 'CJEU'), in its judgment in Case C-538/20 of 22 September, ruled that a Member State may deny a deduction of final losses of a permanent establishment resident in another state, where the country of residence has waived its power to tax the profits of that permanent establishment under a double taxation convention.

Foreword

A public limited company established in Germany (hereinafter 'W AG'), manages a German securities bank. In August 2004, it opened a branch office in the United Kingdom, which did not generate any income during the first three years and it was decided to close it in the first half of 2007. Since those losses could not be carried forward for tax purposes in the United Kingdom, W AG included them in its German tax return for 2007 but the competent tax office did not recognise them for the purposes of calculating corporation tax (*Körperschaftsteuergesetz,* hereinafter 'KStG') and trade and industry tax (*Gewerbesteuergesetz,* hereinafter 'GStG'). W AG appealed to the Hessen Tax Court (*Hessiches Finanzgericht*), which upheld this appeal in its judgment of 4 September 2018, and the Tax Office subsequently appealed against this judgment by cassation to the Federal Tax Court (*Bundesfinanzhof*).

The latter pointed out that although W AG is subject to corporation tax in Germany for all its income (Paragraph 1(1) and (2) of the KStG), the losses incurred by its permanent establishment in the United Kingdom are excluded from the basis of assessment for corporation tax pursuant to Paragraph XVIII(2) of the German/UK Double Taxation Agreement and is likewise excluded from the basis of assessment for trade and industry tax (*GStG*). On the basis of these elements, the appeal should be allowed. However, the Federal Tax Court judge raised the question of whether the losses incurred by the permanent establishment in the United Kingdom should not be taken into account for the calculation of the tax owed by W AG in Germany in view of the freedom of establishment and, as he did not consider the relevant ECJ ruling to be sufficiently clear, decided to suspend the proceedings by submitting the following questions to the ECJ for a preliminary ruling.

Is Article 49 in conjunction with Article 54 of the Treaty on the Functioning of the European Union ('TFEU') to be interpreted as precluding a tax system of a Member State under which a company resident in that Member State may not deduct from its taxable profits the final losses of a permanent establishment in another Member State where that State has waived its power to tax the results of that permanent establishment under a double taxation convention? If the answer to the first question is in the affirmative:

- Do the same Articles 49 and 54 also preclude the provisions of the German Law on Trade and Industry Tax prohibiting a resident company from deducting from its taxable profits the final losses incurred by a permanent establishment situated in another Member State?
- Whether, in the event of the closure of the foreign permanent establishment, the losses may be considered definitive by virtue of the theoretical possibility that the company may open a new permanent establishment in the same foreign State and its profits may possibly be set off against the previous losses;
- Whether in the event of the closure of the foreign permanent establishment, losses that may be carried forward under local law to a subsequent financial year may also be considered final;
- Whether final cross-border losses are limited in *quantum* by the amounts of losses that the company could have claimed in the State of location of the permanent establishment.

Analysis of the CJEU

With regard to the first question, the CJEU notes that companies resident in Germany are subject to tax on all income pursuant to § 1 (paras. 1 and 2) of the KStG and, however, under the Double Taxation Agreement, if a German company carries on its industrial or commercial activity in the United Kingdom through a permanent establishment, profits attributable to that permanent establishment (and therefore losses) are excluded from the basis of assessment for corporation tax payable in Germany.

A recent CJEU ruling, in particular Judgment C-650/156 'Bevola and Jens W. Trock' of 12 June 2018, affirmed that the freedom of establishment guaranteed by Articles 49 and 54 TFEU includes the right for companies of one Member State to carry out their activities in another Member State through a subsidiary, branch or agency (and this freedom must not be impeded by the legislation of the Member State where the company is located). This ruling states that resident companies enjoy a tax advantage in determining their taxable income consisting of being able to take into account losses incurred by a resident permanent establishment. Excluding this possibility in the case of losses incurred by a foreign permanent establishment may dissuade a resident company from carrying on its business through that permanent establishment, and therefore such a difference in treatment is only permissible when it concerns situations that are not objectively comparable (or justified by a general interest motive).

In its previous judgment C-388/14 'Timac Agro Deutschland' of 17 December 2015, the CJEU had ruled that where the Member State of residence of a company has waived, by virtue of a double taxation convention, the exercise of its power of taxation on the profits of a permanent establishment resident in another Member State, the situation of that company is not comparable to that of a resident company with a permanent establishment.

This conclusion was not called into question by the judgment C-650/156 'Bevola and Jens W. Trock' of 12 June 2018. In that case, the CJEU held that the situation of a company with a foreign permanent establishment that had definitive losses, which were no longer deductible following the closure of the permanent establishment, was no different from that of a resident company with losses attributable to a resident permanent establishment. However, in that case, the Member State of residence of the company seeking recognition of the definitive losses of its foreign permanent establishment had not waived its power to tax the income of that establishment by virtue of the application of a double taxation convention. It had unilaterally decided not to take into account profits and losses realised by non-resident permanent establishments, although it would have had the power to do so, and therefore that situation was not comparable to that in Case C-388/14 'Timac Agro Deutschland'.

Conclusions

In Case C-538/20 of 22 September 2022, the Federal Republic of Germany waived its power to tax the profits made by a permanent establishment in the United Kingdom (and symmetrically to take into account its losses) under the existing double taxation convention, and as a result, a resident company with such a permanent establishment is not in a comparable situation to a resident company with a permanent establishment in Germany.

The CJEU therefore concludes that no restriction on the freedom of establishment can be discerned in the present case and that Articles 49 and 54 TFEU must be interpreted as not precluding a tax regime of a Member State under which a company resident in that Member State cannot deduct from its taxable profits the losses permanent establishment situated in another Member State where the Member State of residence has waived its power to tax the results of that permanent establishment by virtue of a convention for the prevention of double taxation, and in view of that conclusion there is no need to answer the other questions referred for a preliminary ruling.

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CHILE: TAX REFORM PROJECT

The Chilean Ministry of Finance recently published a preview of its tax reform project. Below is a brief summary of the main changes it would like to make:

Income tax – partial disintegration

The tax reform project refers to a 'semi-dual' system applicable to corporations, which separates the taxation of corporations and their shareholders. Corporate income tax would no longer be a credit against shareholder tax; both taxes would be added.

The bill would eliminate tax integration, whereby Chilean shareholders would not be able to claim tax credits for taxes paid by companies. Consequently, a fixed tax rate of 22% would apply to distributed dividends.

Individual shareholders resident in Chile with an effective tax rate below 22% may treat dividends as income subject to the individual income tax rate.

The bill subjects foreign shareholders to one of two corporate income tax regimes:

- Foreign shareholders resident in a non-convention country: they would no longer be able to apply a corporate tax credit against withholding tax on dividends. A dividend tax of 22%, called capital gains tax, would apply to dividend distributions and would be withheld at source.
- Foreign shareholders resident in convention countries: they would remain subject to the current regime of 35% withholding tax on dividends, with the right to use 25% corporate income tax (currently 27%) as a credit.

Rental income

The current exemption for rental income would be eliminated. Currently, provided the property meets certain requirements, taxpayers may exempt rental income from taxation for up to two properties.

The reform proposes to eliminate this exemption; therefore, all rental properties would be subject to tax as of 1 January 2023.

Exit tax

The bill also provides for an exit tax for persons with assets over USD 4.9 million who lose their domicile or residence in Chile. Under this new provision, taxpayers who submit an application for a 'loss of domicile' certificate to the Chilean authority will be subject to a one-off tax of 5% on their total wealth assessed according to the wealth tax valuation rules.

Wealth tax

The tax reform envisages the introduction of an estate tax on assets held in Chile and abroad by Chilean tax residents. Assets with a value between USD 4.9 million and USD 14.7 million would be subject to an annual wealth tax of between 1% and 1.8%.

Personal assets between 0 and 4.9 million exempt from tax, between 4.9 million and 14.7 million a tax rate of 1% applies and between 14.7 million and above a tax rate of 1.8% applies.

It is important to note that taxpayers with total assets below the minimum threshold (i.e. $4.9 million) will still have to file an informative wealth declaration if their assets exceed $3.2 million.

To determine the tax base, the following rules would apply:

Total assets, trusts and other arrangements: The tax base would take into account all assets that the taxpayer owns, directly or indirectly, or to which they are entitled. In the case of trusts, all underlying assets of which the taxpayer is the ultimate beneficiary would be taken into account. If the trust were revocable, its net assets would be added to the settlor's tax base.

Private interest foundations and other fiduciary arrangements would also be included, regardless of whether they qualify as legal entities, if the taxpayer has made contributions or is one of the beneficiaries.

Unemancipated children: Taxpayers must consider the assets of children under the age of 18, provided they have custody. If parents have shared custody, the bill requires each parent to consider 50% of the children's assets.

Inheritance shares: The bill would include inheritance shares in the tax base, regardless of the domicile of the deceased and the location of the inherited assets. Inherited property or assets subject to inheritance tax would not be included in the estate tax base in the year in which the inheritance tax was paid, but would have to be included in subsequent years.

Donations: Donations would be excluded from the tax base, provided they are subject to gift tax, but only in the year in which the tax was paid or an exemption was granted.

New 'development surcharge' and investment incentives

According to the tax reform, the corporate income tax rate would be 25 per cent, however, a 2% tax rate would be added, which might not be levied if the company is engaged in 'productivity investments'.

Productivity investments' are defined as:

- Research and Development (R&D) investments under the R&D Incentives Act;
- The acquisition of high-tech production facilities and services developed or produced in Chile, or imported and sold by Chilean suppliers,
- Costs related to the protection and registration of certain intellectual property, provided that the object of protection was produced or invented in Chile.
- Expenses for obtaining International Organisation for Standardisation (ISO) certifications.

New tax on undistributed profits

The bill would impose a 1.8% tax on retained earnings if 50% or more of their annual gross income is derived from passive income. The bill considers the following income as passive:

- Dividends and profit distributions from companies in Chile or abroad;
- Accrued income from preferential tax regimes;
- Interest from lending/financing transactions and income from financial instruments;
- Royalties, unless they come from research projects under the R&D Incentives Act or from assets created by the company;
- Capital gains from the sale of assets generating royalties, dividends or interest, including the sale or transfer of crypto-assets;
- Income from the rental of real estate.

The bill does not consider income from the transfer of real estate to be passive, provided that the taxpayer's main activity is not related to the generation of passive income and that the taxpayer has not been subject to the new 1.8% rate for the last three years.

Limits to the Utilisation of Tax Losses

While allowing the carry-forward of losses indefinitely, the bill allows taxpayers to deduct losses only up to 50% of the net taxable income determined in the year in which the deduction is applied. A transitional limitation of 75% would apply for the calendar year 2024.

Capital Gains Tax

A new capital gains tax will be introduced and it will tax Chilean securities. Until the introduction of Law No. 21.420 of February 2022, capital gains from securities listed on the Chilean stock market were not subject to tax. As of 1 September 2022, these capital gains were subject to a flat tax of 10%. The reform proposes a further increase of this rate to 22%.

Limitations on Foreign Tax Credits

The bill would eliminate indirect foreign tax credits, i.e., foreign taxes paid by companies indirectly controlled by Chilean entities could no longer be claimed as foreign tax credits in Chile. Therefore, Chilean entities would only be able to claim as tax credits foreign taxes paid by directly controlled companies.

The possibility of claiming a tax credit for Chilean withholding tax paid by companies indirectly controlled by Chilean entities would also be eliminated.

Private and public investment funds

Currently, public and private investment funds are not subject to corporate income tax. The bill subjects private investment funds to corporate income tax of 25%, unless they invest in venture capital. Public investment funds would retain their exemption from corporate income tax, but profit distributions to shareholder companies would be taxed according to the general rules. The bill would also eliminate the 10% preferential withholding tax on profit distributions and instead impose the 22% dividend tax on profit distributions made abroad.

Value Added Tax

The bill would amend the value added tax (VAT) rules as follows:

- Extend the simplified online VAT filing platform for digital service providers to all foreign sellers or service providers with VAT-liable transactions in Chile who provide remote services;
- Strengthening of the legal presumption of territoriality for services (such as IP address, billing address, etc.), to cover more cases of services rendered remotely, instead of only digital services taxed with VAT;
- Limit the refund of VAT on exports to 19% of the value of the exported goods or services.

Small and Medium Enterprises

According to the new bill, the regime for medium and small enterprises (SMEs) would apply to taxpayers whose average income over the past three years is less than about USD 2.5 million. The corporate tax rate would be 25%. In addition, SME owners would not be subject to the new 22% dividend tax.

New SMEs that start business up to six months before the bill is published could claim a special VAT tax credit for the first year of operation. The credit would be 100% of the VAT for the first three months in which the company makes sales or provides services; 50% for the next three months; and 25% for the following six months.

The bill would also allow SMEs to claim 5% of their R&D expenses as a corporate income tax credit.

Amendments to the anti-avoidance rules

The bill would strengthen the anti-avoidance measures by making the following changes:

- Creation of a register of final beneficiaries, Chilean natural persons and foreign taxpayers who are partners or shareholders in companies with a shareholding of more than 10%;
- Introduction of the *whistle-blower* concept in the tax law, which would allow a *whistle-blower* to anonymously report tax offences and receive compensation of up to 10% of the fines collected;
- Reduction of penalties applicable to defendants accused of tax offences who cooperate substantially with the prosecutor's investigation.

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