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European Union: German dividend withholding tax violates the principle of free movement of capital (ECJ, October 20, 2011, C 284/09) – Impact on the French withholding tax levied on outbound dividends paid to European pension funds and certain minority shareholders?

Administration of dividend withholding tax within Europe

Pursuant to the freedom of establishment and the free movement of capital guaranteed by the Treaty of the Functioning of the EU ("TFEU") and the European Economic Area Agreement ("EEA"), domestic legislation of EU countries must provide for equivalent tax treatment of corporate shareholders that are resident of other EU and EEA countries and their resident corporate shareholders.

To eliminate tax barriers to the freedom of establishment within the EU, the EU Parent-Subsidiary Directive (Council Directive 90/435/EEC) implemented a withholding tax exemption on outbound dividends paid by an EU subsidiary to its parent company established in another EU country, holding at least 10% of its share capital (among other conditions).

However, there is no EU directive eliminating tax restrictions on the free movement of capital for EU resident shareholders holding a less than 10% shareholding. Hence, domestic legislation of EU countries must be administered in such a way to guarantee equivalent tax treatment of resident and non-resident EU shareholders.

The European Court of Justice ("ECJ") decided in a recent judgment (C 284/09) (the "ECJ Judgment") that the German dividend withholding tax as currently administered violates the principle of free movement of capital of the EU/EEA Treaties, allowing non-German corporate shareholders to claim for a refund of substantially all of the German dividend withholding tax paid on dividends received after January 1, 2008.

Although the ECJ Judgment pertains to the German dividend withholding tax mechanism, it also has implications for the compatibility of the French withholding tax levied on outbound dividends paid to EU investment funds and certain corporate shareholders holding a less than 5% shareholding in a French company.

Synopsis

The ECJ decided in a judgment rendered on October 20, 2011 (C 284/09) that the German withholding tax violates the principle of free movement of capital guaranteed by the TFEU/EEA Treaties.

The ECJ Judgment requires the residents of EU and EEA countries to be treated in an equivalent manner to German shareholders.

Yet, currently, Germany applies a withholding tax of 26.375% (25% income tax plus 5.5% Solidarity Surcharge thereon) to all dividend distributions, although non-German corporate shareholders (neither resident in Germany nor holding the shares through a German permanent establishment) can reduce the withholding tax to 15.825% if they fulfill certain activity requirements.

In comparison, German shareholders can receive a refund of substantially all of the withholding tax (with a remaining corporate income tax burden of only 0.8 %).

As a consequence, non-German corporate shareholders are entitled to apply for recovery refund of the excess withholding tax paid (approximately 15%) on dividends received after January 1, 2008.

To date, no judgment similar to the ECJ Judgment has been rendered with respect to the compatibility of the French dividend withholding tax with the free movement of capital.

However, the ECJ Judgment clearly raises questions about the compatibility of the French withholding tax levied on outbound dividends paid to EU investments funds and certain corporate shareholders holding a less than 5% shareholding in a French company.

The ECJ Judgment

Background

Currently, Germany applies a withholding tax of 26.375% (25% income tax plus 5.5% Solidarity Surcharge thereon) to all dividend distributions. However, all corporate shareholders resident in Germany or holding the shares through a German permanent establishment ("German Shareholders") are subject to assessment procedures for corporate income tax. In such assessment they are in principle largely exempt from corporate income tax with respect to their German dividend income and effectively taxed only on 5% of such dividend income (as deemed non-deductible expenses effectively connected with such dividend income). Therefore, they receive a refund of almost the complete amount of the withholding tax with a remaining corporate income tax burden of only 0.8%, irrespective of the percentage of their participation in the company making the distribution, and of the nature and extent of their own business activities. This exemption does not apply to banks or other finance companies holding the shares as current assets for short term trading ("Trading Shares"). However, in that case a German Shareholder can deduct all expenses and losses incurred in connection with Trading Shares to off-set the dividend income as part of the assessment process. This applies in particular with regard to losses from the write-down or sale of the shares after the dividend date. Therefore, the dividend income is typically much reduced or even completely compensated by expenses and losses in these cases and, as a consequence, the withholding tax largely or completely refunded.

Non-German corporate shareholders (neither resident in Germany nor holding the shares through a German permanent establishment) ("Foreign Shareholders") are not subject to German tax assessment proceedings with respect to their German dividend income. If they fulfill certain activity requirements, the withholding tax is (upon application) reduced by 2/5 of the normal rate (to 15.825% of the dividend) ("2/5 Refund"). For shareholders holding a participation of 10% or more, the withholding tax may be further decreased (typically to 10% or 5% but sometimes even to 0%) by an applicable tax treaty ("Treaty Reduction") and for shareholders resident in an EU country to 0% under the EU Parent-Subsidiary Directive ("Participation Exemption"), however, always subject to certain activity requirements and minimum holding periods. As a result, Foreign Shareholders holding a participation of less than 10% or failing to comply with the activity or holding period requirements remain subject to a much higher German tax burden on their dividend income than German Shareholders, of 15.825% of the dividend.

Consequences for Foreign Shareholders

The ECJ Judgment requires Germany to change its withholding tax system to eliminate this restriction on the free movement of capital. For the future, there are several possible solutions, including a general restriction of the exemption of dividend income to corporate shareholders (including German Shareholders) complying with the requirements of the Participation Exemption.

In respect of the past, however, it is not lawful to impose an additional tax liability on German Shareholders. Therefore, Germany can only comply with the ECJ Judgment for dividend income taxed in the past by refunding the withholding tax to Foreign Shareholders to the same extent a German Shareholder is exempt.

In principle, the free movement of capital rules apply not only to residents of EU countries but to everyone. However, the ECJ Judgment explicitly includes only the EU and EEA countries and the German tax authorities have a general tendency to restrict the application of EU rules and ECJ judgments to EU residents. Therefore, it may be assumed that Germany will not apply the ECJ Judgment beyond the EU /EEA territory.

Consequently, all Foreign Shareholders resident in the EU or the EEA who are not benefitting from a Participation Exemption should be eligible for a refund of 3/5 of the German tax withheld on their dividend income (15.825%) not already covered by the 2/5 Refund or a further Treaty Reduction. This refund claim may be subject to the deduction of a tax charge on 5% of the dividend (effective tax burden of 0.8%) to account for the tax burden of a German Shareholder.

Process Required to Recover German Withholding Tax

There are only formal proceedings in place for a withholding tax refund to a Foreign Shareholder who benefits from a Participation Exemption or a Treaty Reduction and for the 2/5 Refund. There are currently no proceedings specified for refunds beyond that based on the ECJ Judgment. Therefore, the taxpayer must apply for a refund under the general rules for tax overpayments, i.e. by applying for a refund to the local tax office that received the relevant withholding tax payment. Therefore, a refund application must be sent in principle to each tax

office at the location of any German corporation from which the Foreign Shareholder received a relevant dividend. However, there are currently discussions as to whether applications to the Federal Central Office for Taxes, which is responsible for dealing with Treaty Reductions and Participation Exemption and 2/5 Refund procedures, should be permitted in the interest of efficiency.

The relevant German statute of limitations for this kind of refund is four years after the end of the calendar year in which the dividend was received. Therefore, it is currently possible to apply for a withholding tax refund for dividends received in or after 2008.

Some tax offices may reject refund claims right away. In that case, the taxpayer would have to file for an appeal and possibly go to tax court to preserve the right to receive the refund, unless proceedings are stayed to wait for guidance by the German Federal Ministry of Finance (BMF).

The Impact of the ECJ Judgment on the French dividend withholding tax

Although the ECJ Judgment pertains to the German dividend withholding tax, a similar tax that France imposes could potentially be challenged by the ECJ in the future when levied on outbound dividends paid to European companies holding a minority shareholding representing less than 5% of the share capital of the French distributing company, if the recipient company cannot eliminate the French tax burden.

French dividend withholding tax on outbound dividends

France imposes a 30% withholding tax on outbound dividends[1] paid by a French company to a non-French company, whereas no tax is withheld on dividends paid to a French recipient. This withholding tax can be reduced (or eliminated) under the provisions of double tax treaties; when applicable, double tax treaties generally provide for the elimination of the double taxation through the mechanism of a tax credit, which can be offset against the tax due in the country of establishment of the recipient company on this dividend income. Hence, when no tax is due on such income by the non-French recipient (either because they have accumulated tax loss carry forwards or because they benefit from a specific corporation income tax ("CIT") exemption in their country of residence), the French withholding tax becomes final; whereas a French recipient would not suffer any tax burden under the same circumstances. As a result, in those specific situations, the French dividend withholding tax can be discriminatory against non-French recipient companies.

Dividend withholding tax exemption within Europe

As discussed above, within the EU, the Participation Exemption[2] applies to dividends paid to an EU-established company that holds at least 10% of the share capital of the French distributing company, subject to the fulfillment of certain conditions.

Further, the ECJ has ruled previously that the French dividend withholding tax was contrary to the freedom of establishment guaranteed by the TFEU when levied on dividends paid to a European recipient that holds at least 5% of the capital of the French paying company that cannot use the corresponding tax credit to eliminate this tax burden, since a French recipient company would suffer no taxation on such dividend under the French participation exemption regime[3].

As a result, the French tax authorities[4] extended the dividend withholding tax exemption to those situations where the European[5] recipient company holds a 5% shareholding in the French distributing company for a minimum two-year period and that cannot offset the corresponding French tax credit against the tax due locally on the dividend income, notably when this income is exempt or when the recipient company is in a loss-making position.

Therefore, unlike Germany, European companies holding a 5% shareholding for a two-year period in a French company are not treated less favorably than a French resident company eligible for the French participation exemption as a result of the French dividend withholding tax.

[1] Section 119 bis of the French tax Code.

[2] EU Directive n°90-435 dated July 23, 1990, codified under Section 119 ter of the French tax Code.

[3] ECJ, Denkavit International and Denkavit France, C-170/05, December 14, 2006.

[4] French administrative guidelines 4 C-7-07 dated May 10, 2007 and 4 C-8-07 dated July 12, 2007.

[5] The dividend withholding tax exemption applies to recipient companies established within the EU or in a member state of the EEA that has entered into a double tax treaty providing for an administrative assistance clause with France.

Potential infringement on the free movement of capital

Regarding European companies holding a shareholding of less than 5% in French companies, they are generally not treated less favorably than French shareholders holding the same percentage of shares, since the latter are fully taxed on their dividend income at the standard CIT rate of 33.1/3%. However, discriminatory treatment may exist when the European recipient is not in a position to eliminate the French withholding tax, (e.g., if it is in a net tax loss position). Hence, in this specific case, it could be decided that the French withholding tax infringes on the free movement of capital guaranteed by the TFEU and EEA Treaty.

The question thus arises as to whether, in such a case, a claim for refund could be filed on the basis of the ECJ Judgment.

Generally, under French tax legislation,[6] a refund claim can be filed on the basis of a judgment of a Supreme Court[7] (including the ECJ), that reveals the non-conformity of a set of rules with a higher one.

According to the French tax authorities[8], a claim may be filed on the basis of a judgment of the ECJ only to the extent that such judgment is rendered in respect of French legislation. Judgments rendered in respect of the legislation of a foreign jurisdiction do not allow a tax payer to file a claim relating to French taxes. It is worth mentioning, however, that in a recent decision,[9] the French Supreme Administrative Court mitigated this position and considered that a judgment pertaining to a law of another member State could, if it provides for an interpretation of a directive that reveals the non-conformity of its transposition under French law, constitute a valid decision to file a claim on the basis of section L.190 of the FTC.

On the basis of applicable doctrine and status of French and ECJ case law and since the ECJ Judgment does not reveal any guidance as to the interpretation of a directive, a claim could only be filed on the basis of a judgment rendered by a French Supreme Court.

[6] Section L. 190 of the French Fiscal Procedures Code ("FTC").
[7] The Supreme Courts are (i) the French Supreme Administrative Court ("Conseil d'Etat"), (ii) the French Highest Court of Justice ("Cour de Cassation"), (iii) the French Tribunal of Conflicts ("Tribunal des Conflits") and (iv) the ECJ.
[8] French administrative guidelines, 13 O-1-06 §28.
[9] Opinion of the French Supreme Administrative Court ("Avis du Conseil d'Etat"), May 23, 2011 n°344678, 9° and 10°s.-s., Société Santander Asset Management SGIIC SA.

Regarding the status of French case law on the subject, a French court recently ruled that the French dividend withholding tax was an infringement on the free movement of capital guaranteed by the TFEU, in line with the position held by judges in the ECJ Judgment and under very similar circumstances.

In this case, French withholding tax had been levied on dividends distributed by two French companies to a Luxembourg shareholder holding 0.011% and 1.34%, respectively, of the share capital of the distributing French companies. The withholding tax had been levied at the reduced rate of 15% provided for by the French-Luxembourg tax treaty, carrying a non-refundable tax credit equal to the French withholding tax which could be offset against the income tax levied on such income in Luxembourg. However, since the Luxembourg recipient company was in a loss-making position, it was not in a position to use this tax credit to eliminate the French withholding tax burden.

The French court ruled that the French withholding tax mechanism did not eliminate the tax burden in the particular case where considering the loss-making position of the recipient company, the corresponding tax credit could not be used. As a result, the court considered that the mechanism was discriminatory against non-French companies, given that French recipients would not suffer any taxation under the same circumstances.

However, since this decision was rendered by an administrative court of appeal (French administrative Court of appeal of Versailles[10]) and not by a Supreme Court, it does not allow the filing of a refund claim under the above-mentioned section L. 190 procedure. The French tax authorities have filed an appeal against the judgment. If the French Supreme Administrative Court confirms the judgment, European companies should have valid grounds to file a refund claim under the section L. 190 procedure.

In any case, and although it will need to be confirmed, the decision rendered by the administrative court of appeal gives insight on the current position of French judges regarding the application of dividend withholding tax in Europe.

In parallel, it is worth mentioning another potential infringement, by France, on the free movement of capital. Such infringement relates to French source dividends paid to foreign pension and investment funds. These

[10] French administrative Court of appeal of Versailles, 1st Chamber, June 7, 2011, n°10VE00115, SA Kermadec.

dividends are subject to a 30% withholding tax (subject to reduction under an applicable tax treaty) whereas they are tax exempt when paid to French funds.[11]

This difference in treatment has led the European Commission to file a suit against France before the ECJ on March 18, 2010, and, more recently, French courts *(Tribunal de Montreuil*) to raise the question of the compatibility of the French withholding tax on dividends paid to EU investments funds. As a result, the French Supreme Administrative Court referred the Montreuil case before the ECJ.[12]

Conclusion

Pursuant to the ECJ Judgment, non-German corporate shareholders are entitled to apply for a refund of the excess withholding tax paid on dividends received after January 1, 2008.

From a French perspective, no modification of the French dividend withholding tax mechanism has been proposed to date, either by the legislature or by the French tax authorities. However, although France is ahead of Germany as regards the alignment of domestic law with EU principles, there are still grounds for the EU courts to challenge the French withholding tax mechanism on outbound dividends. New developments are thus expected to arise, considering not only the latest judgments of the ECJ in this respect but also the pending case before the ECJ in respect of the French withholding tax levied on dividends paid to foreign funds. Since France is one country among others to discriminate between domestic and EU funds[13], the outcome of such case could have a significant impact on the dividend withholding tax mechanism within European as a whole.

[11] Although France introduced (i) new provisions in its Bill of Finance for 2010 to impose dividends received by French not-for-profit organizations (including pension funds) at a flat rate of 15% and (ii) administrative guidelines 4 H-2-10 dated January 15, 2010, to apply the same 15% tax rate to French source dividends paid to EU pension funds that meet the same conditions as French pension funds, the European Commission considered that these new rules remain discriminatory because the conditions imposed on EU pension funds to benefit from the 15% withholding tax rate are too strict and rigid.

[12] Opinion referred under footnote n°5. The court of Montreuil made a preliminary ruling request n°2011/C 269/66 before the ECJ on July 4, 2011.

[13] The European Commission has also filed a suit against Poland in 2009 and against Belgium in 2010.

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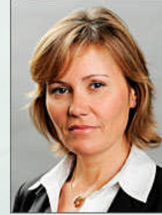

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