Update on jurisdiction of the European Court of Justice regarding withholding tax on cross-border dividends

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In Brief

The European Court of Justice recently ruled that the refusal to exempt dividends received by parent companies in one Member State from withholding tax is incompatible with both the European freedom of establishment and with the Parent-Subsidiary Directive. A long time criticised rule was therefore rejected by the European higher court and the chances of successfully applying for withholding tax exemption certificates or refunds are substantially increased.

Cross-border dividends within the European Union

Background

Article 5 paragraph 1 of the Parent-Subsidiary Directive establishes the principle that withholding tax on profits distributed by a subsidiary established in one Member State to its parent company established in another Member State is prohibited. Thus, given that the Parent-Subsidiary Directive is intended to streamline the tax principles governing cross-border cooperation within the European Union, Member States cannot unilaterally introduce restrictive measures and enforce their domestic right to apply conditions to this exemption from withholding tax under Article 5 paragraph 1. Nevertheless, there is an exception to this principle in Article 1 paragraph 2, which gives Member States the ability to apply domestic or contractual provisions, where required for the prevention of fraud or abuse, as well as in order to protect the domestic tax base created by a directive. However, Member States may, in any event, exercise this option only whilst observing the general principles of EU law and, more specifically, the principle of proportionality.

In general, under current German tax law dividends distributed by a German subsidiary to a non-resident parent company are either, on application by the taxable person, exempt from income tax, or subject to withholding tax, which can be refunded, also upon application. However, under Section 50d paragraph 3 of German Income Tax Act, in the version amended by the Annual Tax Act 2007 dated 13 December 2006, the entitlement to exemption or a refund is precluded where, (i) the non-resident parent company's shareholders would not have been entitled to the exemption or a refund if they had received those dividends directly; and (ii), one of three conditions is satisfied, namely, (a) if there are no economic or other substantial reasons for the involvement of the non-resident parent company; (b)the non-resident parent company does not earn more than 10% of its entire gross income for the financial year in question from its own economic activities (there being no such activity, inter alia, if the company earns its gross income from the management of assets); or (c) if the non-resident parent company does not take part in general economic commerce with a business establishment suitably equipped for its business purpose.

The European freedom of establishment, which Article 49 TFEU grants to EU nationals, includes the right to take up and pursue activities as self-employed persons and to set up and manage undertakings under the conditions laid down for its own nationals by the law of the Member State where such establishment is affected. It entails, in accordance with Article 54 TFEU (for companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the European Union) the right to exercise their activity in the Member State concerned through a subsidiary, a branch or an agency. All measures which prohibit, impede or render less attractive the exercise of freedom of establishment must be considered as restrictions on that freedom. They can only be justified in situations which are not objectively comparable or if it is justified by overriding reasons in the public interest recognised by EU law. It is further necessary, in such a case, that the restriction be appropriate for ensuring the attainment of the objective that it pursues and does not go beyond what is necessary to attain it.

Latest case law

Very recently, the European Court of Justice (Joined Cases C-504/16 and C-613/16) ruled that it must be found that Article 1 paragraph 2 in conjunction with Article 5 paragraph 1 of the Parent-Subsidiary Directive must be interpreted as precluding national tax legislation, such as that debated in Germany. The latter was found as going far beyond targeting only the permitted tax fraud and abuse cases. Rather, a number of constellations were suspected to be abusive without the ability to prove anything to the contrary. Also, typical "passive" holding structures must not be per se treated as abuse, but can demonstrate business functions and purpose legitimately.

This judgment is highly relevant for cross-border industrial groups, as well as holding and investment structures having German subsidiaries which are repatriating proceeds via dividend payments to their parent company in other Member States. The relief from withholding tax on these profit distributions should now be much easier to achieve.

For international real estate structures it is remarkable that the court explicitly stated that economic activity of a non-resident parent company consists of the management of its subsidiaries' assets and that income earned from such management cannot per se indicate the existence of a wholly artificial arrangement that does not reflect economic reality.

It is important to understand that the current version of Section 50d paragraph 3 of the Income Tax Act deviates slightly from the previous one subject to the discussed ECJ judgment. However, this is still using almost the same criteria and, applying the arguments of the ECJ, seems very much the same to be not at all focusing on purely tax fraud or abusive fact patterns. Therefore, another case that has been submitted to the ECJ on this version of the law (Case C-440/17) should very likely be resolved with the same outcome.

Our view

In our opinion, the judgment is much appreciated as it rejects a long time criticised rule as being incompatible with the European freedom of establishment. We also see that this decision affects a lot of our clients investing in German Real Estate via holdings resident in other European Member States. There are also broader implications for anti-treaty shopping rules being applied between Member States, which may be more burdensome for tax authorities to prove following this ruling.

A more detailed NewsAlert will follow shortly.

Contact

Uwe Stoschek
Global Real Estate Tax Leader
Phone: +49 30 2636-5286
uwe.stoschek@de.pwc.com

Jeroen Elink Schuurman
EMEA Real Estate Tax Leader
Phone: +31 88 792-6428
jeroen.elink.schuurman@nl.pwc.com

Germany

Sven Behrends
Partner, München
Phone: +49 89 5790-5887
sven.behrends@de.pwc.com

Helge Dammann
Partner, Berlin
Phone: +49 30 2636-5222
helge.dammann@de.pwc.com

Marcel Mies
Partner, Düsseldorf
Phone: +49 211 981-2294
marcel.mies@de.pwc.com

Dr. Michael A. Müller
Partner, Berlin
Phone: +49 30 2636-5572
mueller.michael@de.pwc.com

Josip Oreskovic-Rips
Partner, Frankfurt am Main
Phone: +49 69 9585-6255
josip.oreskovic-rips@de.pwc.com

Uwe Stoschek
Partner, Berlin
Phone: +49 30 2636-5286
uwe.stoschek@de.pwc.com