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German Tax and Legal News

CJEU confirms application of free movement of capital provisions where domestic rules require minimum participation

The CJEU has confirmed that the free movement of capital provision applies to domestic rules on the taxation of dividends received from third-country shareholdings of at least 10%.

On 11 September 2014, the Court of Justice of the European Union (CJEU) ruled on a measure found in the German imputation system that applied until 2001. Under the rules and the tax treaties in effect in the years at issue, dividends received by a German corporation from foreign subsidiaries in which the recipient held at least 10% were exempt from German tax. However, dividends received from a German subsidiary were included in the taxable income of the recipient parent company, with a credit granted for underlying corporate income tax paid by the subsidiary. If the parent company did not have to pay tax in a particular year (for example, due to an overall loss position), the credit resulted in a refund of tax.

The CJEU decision may entitle certain third-country parent companies of Germany subsidiaries to a refund of German withholding tax on dividends, even if the dividends were paid after the abolishment of the dividend exemption for shareholdings less than 10% on 28 February 2013.

Germany's old imputation system was referred to the CJEU in the Meilicke cases (C-292/04 and C-262/09) and was held to be incompatible with the fundamental freedoms under the Treaty on the Functioning of the European Union (TFEU) to the extent foreign-source dividends were taxed without granting a credit similar to that available in cases of German-source dividends. However, in both C-262/09 and in another decision (FII GLO, C-446/04), the CJEU held that the fundamental freedoms do not require EU member states to refund a tax that originates in the tax system of another member state. In the Kronos case, although no credit was available under the version of the imputation rules considered by the CJEU, the foreign-source dividends also were not subject to tax. The CJEU held that the differing treatment that applied to foreign-source (exempt) and domestic (taxable with a credit) dividends did not give rise to a violation of the fundamental freedoms because both methods achieved the objective of the domestic legislation, since they both eliminated the risk of double taxation of dividends at the level of the state of residence of the recipient.

The main relevance of Kronos, however, lies in the CJEU's statements regarding the applicable fundamental freedom. The case involved (inter alia) a 100% shareholding in Kronos Canada Inc., a company resident in a third county (i.e. a non-EU country). The recipient of the dividends, Kronos International Inc., was resident in Germany, but was not able to invoke the freedom of establishment because it was established under the laws of a third country (the US) and, thus, was not covered by the relevant provisions of the TFEU (articles 49, 54). Because entities from third countries were involved, protection of the fundamental freedoms could be invoked only if the free movement of capital provisions applied. However, based on established CJEU case law, these provisions do not apply to national legislation intended to apply only to those shareholdings that enable the holder to exert a definite influence on a company's decisions and to determine its activities.

The exemption method for foreign dividends under the rules considered in the Kronos case applied only where the shareholding in the subsidiary was at least 10%. In a decision issued in 2012, the German Federal Fiscal Court (BFH) ruled in a similar case that domestic legislation applying only to shareholdings of at least 10% is not covered by the free movement of capital provisions, but only by the freedom of establishment provisions, if applicable (BFH, 29 August 2012, I R 7/12). However, in the Kronos case, the CJEU held that the free movement of capital provisions did apply, reasoning that a 10% threshold, while excluding shareholdings acquired solely with the intention of making a financial investment, is not sufficiently high to be considered applicable to only those shareholdings that enable the holder to exert a definite influence on a company's decisions and to determine its activities. Hence, for dividends originating in a third country and dividends paid to an entity unable to rely on the freedom of establishment, the free movement of capital may apply regardless of the parent's actual participation (since the applicability of these provisions is based on the shareholdings the legislation is intended to cover, rather than the shareholding owned by the parent company).

The Kronos decision and the delineation of the free movement of capital from the freedom of establishment are relevant to third-country investors in the EU, as well as for EU investors in third countries. One example involves the issue of withholding tax refunds in situations where the levy of withholding tax on dividends paid by a German subsidiary to its third-country parent is considered to violate the fundamental freedoms.

As from 1 March 2013, Germany abolished the previous dividend exemption for shareholdings of less than 10%, in an attempt to prevent further discrimination against foreign investors, and it introduced a refund mechanism for withholding tax levied on dividends paid before that date to certain EU investors holding less than 10% of the distributing company. However, third country investors are not eligible for the refund mechanism provided by domestic law. Under the BFH's reasoning, it could be assumed that the law change eliminated third country investors' entitlement to a refund of German withholding tax because either the discrimination had been abolished (for investors holding less than 10%) or the investors were not protected by the freedom of establishment (for investors holding 10% or more); however, the Kronos decision clarifies that withholding tax refund opportunities still may exist for third country investors holding 10% or more of the distributing company. As the free movement of capital provisions may apply where the dividend exemption rules would apply in a domestic case, even in cases involving a 100% shareholding, the restriction of this fundamental freedom was not eliminated by the 2013 law change.

All third-country investors that suffered German withholding tax on a dividend from a substantive shareholding should consider investigating the opportunity to receive a refund of this withholding tax, even if the dividend was paid on or after 1 March 2013.

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