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PRACTITIONERS' CORNER

Preventing Withholding Taxation: ECJ Determines the Character of Tax Refunds

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A tax system that imposes corporate taxation for which a credit is provided at the level of a profit recipient faces tough questions in the context of a cross-border distribution, especially when it comes to EU law and its fundamental freedoms or the limitations of the parent-subsidiary directive. The European Court of Justice dealt with such questions regarding Italian tax law, leading to a ruling in June 2010.[1]

The Issues at Stake

According to the parent-subsidiary directive, dividend distributions among corporations of EU member states must not be subject to a withholding tax burden in the source state if a qualified participation is fulfilled (formerly 25 percent, reduced over time to the current 10 percent).[2] A safeguard clause of the directive allows a withholding tax if imposed by domestic or income tax treaty provisions designed to eliminate or lessen economic double taxation.[3]

On some occasions, the ECJ had to rule on whether the goal of the parent-subsidiary directive to prevent withholding taxation is violated by the source state because of domestic tax law or income tax treaties. The following were the most important issues of those withholding cases:

- In *Epson Europe*, the ECJ held that the term ''withholding tax'' of the parent-subsidiary directive ''relates not only to corporation tax but also to any taxation, of whatever nature or however described, which takes the form of a withholding tax on dividends distributed by such subsidiaries.''[4] The substance-over-form principle was upheld in this ruling, in consideration of the economic effect of a tax that might not be labeled withholding tax but has the same consequences.
- A taxation of profits of the distributing corporation that would not have occurred if no distribution had been made was considered a withholding tax within the meaning of the directive and, as a consequence, a violation thereof in *Athinaiki Zythopoiia*.[5]
- In the German case *Burda*, the ECJ changed the principle developed in *Athinaiki Zythopoiia* and held that an increase of German corporate taxation at the level of the dividend distributing company triggered by a dividend distribution did not constitute a withholding tax; this change was

[1] *P. Ferrero e C. SpA v. Agenzia delle Entrate — Ufficio di Alba* (C-338/08) and *General Beverage Europe BV v. Agenzia delle Entrate — Ufficio di Torino 1* (C-339/08), June 24, 2010.

[2] Articles 1, 2, 3(1)(a), and 5(1) of the parent-subsidiary directive (90/435/EEC from July 23, 1990).

[3] Article 7(2) of the parent-subsidiary directive.

[4] *Ministério Público, Fazenda Pública, and Epson Europe* (C-375/98), June 8, 2000, para. 15.

[5] *Athinaiki Zythopoiia and Elliniko Dimosio (Greek State)* (C-294/99), Oct. 4, 2001, para. 33.

based on the reasoning that the parent-subsidiary directive only covers withholding taxes charged to the shareholder, not taxes imposed at the distributing company's level.[6]

- In *Océ Van der Grinten*, a 5 percent charge provided for under the Netherlands-U.K. income tax treaty imposed on dividends paid by a U.K. subsidiary to its Dutch parent company was considered a withholding tax falling within the scope of the parent-subsidiary directive; such withholding taxation, however, was held not to be prohibited by the directive because it is imposed on the tax credit to which that distribution of dividends related.[7]

From those cases, three things determine whether a tax qualifies as a withholding tax under the directive:

- if the tax triggering event is the payment of dividends;
- if the amount of taxation is determined by the income related to the shares; and
- if the taxable person is the holder of the shares.[8]

The *Ferrero* and *Martini* Cases

The combined cases decided by the ECJ in June 2010 addressed whether the taxation of a refund paid together with a dividend was a withholding tax for purposes of the parent-subsidiary directive. It was not disputed that the taxable persons were the respective parent companies; the last aspect concerning qualification as a withholding tax would have been fulfilled.

The facts underlying the two cases, as well as the applicable Italian tax law rules, are identical and are summarized below.

Ferrero and Martini, both wholly owned Italian subsidiaries of the Dutch companies Ferrero International and General Beverage Europe (GBE), distributed dividends to their parents in 1997 and 1998, respectively. Italian tax law generally grants a tax credit upon a dividend payment in the amount of the tax paid by the distributing company regarding the distributed profits. If a subsidiary distributes more than 64 percent of its declared income, an adjustment surtax (*maggiorazione di conguaglio*) equal to nine-sixteenths of the difference is imposed. According to the Italy-Netherlands income tax treaty, a Dutch resident receiving an Italian dividend is entitled to a refund of an amount equal to the adjustment surtax.[9] This refund is not paid by the tax authorities, but by the dividend distributing subsidiaries; correspondingly, the amount of the refund reduces the Italian corporate income tax liability of the subsidiary.

The Italian tax authorities imposed a 5 percent withholding tax on the dividends and on the refund of the adjustment tax as if the latter portion was also a dividend payment. In the proceedings that followed, the two local tax courts involved (the Turin Tax Court and the Cuneo Tax Court) posed almost identical questions to the ECJ:

- whether the 5 percent withholding on the adjustment surtax is a withholding within the scope of article 5(1) of the directive; and
- whether the safeguard clause of article 7(2) applies to the withholding tax and therefore allows such withholding.[10]

The courts did not question the 5 percent withholding in general, only the 5 percent withholding on the surtax refund.

The ECJ's Ruling

In its ruling, the ECJ recited the general goal of the parent-subsidiary directive: the elimination, through the introduction of a common tax system, of any disadvantage to cooperation between companies in different member states compared with companies of the same member state.[11]

After referring to this general principle, the Court stated that any national taxation, irrespective of its classification under national law, could be covered by the directive's term ''withholding tax.'' The ECJ considered it settled case law that any taxation on income of the source state could be a withholding tax on distributed profits within the scope of article 5(1) of the directive if the chargeable event for the tax is the payment of dividends, the taxable amount is the income from those shares, and the taxable person is the holder of the shares.[12]

That the income tax treaty referred to the refund of the adjustment surtax as dividends was not decisive for the Court. Rather, the ECJ tried to analyze the character of the refund payment made by the dividend distributing subsidiaries and concluded that the decisive issue of the cases was that if the refund qualified as a fiscal payment, a tax thereon could not be considered a withholding tax covered by the directive. If, on the

[6] *Finanzamt Hamburg — Am Tierpark v. Burda GmbH* (C-258/06), June 26, 2008, para. 57.

[7] *Océ Van der Grinten NV and Commissioner of Inland Revenue* (C-58/01), Sept. 25, 2003.

[8] Haunold, Tumpel, and Widhalm, *News aus der EU*, Steuer und Wirtschaft International 2009, pp. 42-43.

[9] Article 10(3) of the Italy-Netherlands income tax treaty.

[10] *Ferrero* (C-338/08) and *GBE (Martini)* (C-339/08), June 24, 2010, paras. 17 and 18.

[11] *Id.* at para. 23.

[12] *Id.* at paras. 25 and 26, referring to *Océ Van der Grinten* (C-58/01), Sept. 25, 2003, paras. 46 and 47, and to *Burda* (C-258/06), June 26, 2008, para. 52.

other hand, the refund were qualified as a profit component, taxation thereon would be a withholding tax covered by the directive.[13]

The Court first looked to the purpose of the adjustment surtax itself and concluded that it was imposed to prevent granting tax credits to Italian parent companies for taxes on profits of the distributing subsidiaries that — for whatever reason — may not yet (or not yet totally) have been paid. In this context the Court pointed out that the adjustment surtax is charged without distinction regarding whether the profits distributed are paid to resident companies or nonresident companies. Based on *Burda*, the ECJ concluded that such corrective tax mechanism does not violate the freedom of establishment regardless of whether the parent company, as a nonresident, is not granted the tax credit in question. Also, the adjustment surtax itself (not the taxation on the refund of the adjustment surtax) was not considered a withholding tax forbidden by the parent-subsidiary directive.[14]

The first conclusion drawn by the ECJ was that, subject to an examination of whether nonresident and resident companies are treated differently in this context to be carried out by the referring court, the adjustment surtax was an additional tax on corporate profits borne by the distributing company, and as such, was not precluded by the directive.[15]

The second conclusion of the ECJ's ruling focused on the qualification of the refund of the adjustment surtax itself, as paid in accordance with the income tax treaty in place; that qualification as either a fiscal payment or as a profit component has yet to be determined by the local tax courts that requested the ruling. The ECJ hinted at the aspects to focus on for this clarification: If the refund were the transfer of a portion of tax revenue resulting from a waiver of the Italian state, the refund would be a fiscal payment. If the Italian tax authorities also waived the tax revenue from the adjustment surtax when the adjustment surtax was not collected by those authorities, but the amounts corresponding to the surtax were transferred directly by the dividend distributing company to the Dutch company, the refund would not be a fiscal payment, and therefore would constitute a profit component. For the latter case, the Court held that the taxation of the refund would constitute a withholding tax covered by the parent-subsidiary directive, since the other two criteria were met: The chargeable event was the distribution, and the taxpayers were the Dutch parent companies.[16]

What the ECJ tries to determine is whether the refund paid by the dividend distributing company is a payment made on behalf of the state or a payment made by the company. The Court's rationale, however, is inadequate in trying to determine whether a tax imposed on such payment is a withholding tax within the scope of the directive; profits that are first reduced by a tax for which a refund is granted result in more profits. Under this perspective an opposite outcome from that of the ECJ would be logical: A refund that is not affected by whether the adjustment surtax is collected is similar to a state subsidy and is therefore a governmental payment instead of profits of the company. What this reverse line of reasoning shows is that the refund payment at stake is financed by profits of the company in either of the two situations set forth by the ECJ; a withholding tax thereon should consequently be considered a withholding within the scope of the directive.

Potential Withholding Safeguarded

If it qualifies as a withholding tax on profit distributions, the withholding might not be considered a violation of the directive, provided it is covered by its safeguard provision of article 7(2): Domestic or income tax treaty rules designed to eliminate or lessen economic double taxation of dividends will not be affected by the directive. The ECJ stated that as a derogation from the general principle of the directive such safeguard provision must be interpreted strictly, and ordered the local tax courts that requested the ruling to determine whether the applicable income tax treaty intended to eliminate or reduce economic double taxation of dividends, and whether imposing the withholding tax at stake did not result in canceling out these effects.[17]

Article 10(3) of the Italy-Netherlands income tax treaty appears to aim to prevent cross-border dividends to the Netherlands from being negatively affected by the corrective tax mechanism applied to purely domestic dividends. Imposing a tax on payments made to fulfill this aim would, at least partially, impede that aim. Therefore, the Italian tax courts should conclude that the safeguard rule of the directive would not allow the withholding tax to be imposed. ◆

[13] *Ferrero* (C-338/08) and *GBE (Martini)* (C-339/08), June 24, 2010, para. 38.

[14] *Id.* at paras. 33 and 34; *see also* Brill, *Gesellschaft- und Wirtschaftsrecht* 2010, p. 360.

[15] *Id.* at para. 35.

[16] *Id.* at para. 39.

[17] *Id.* at para. 47.