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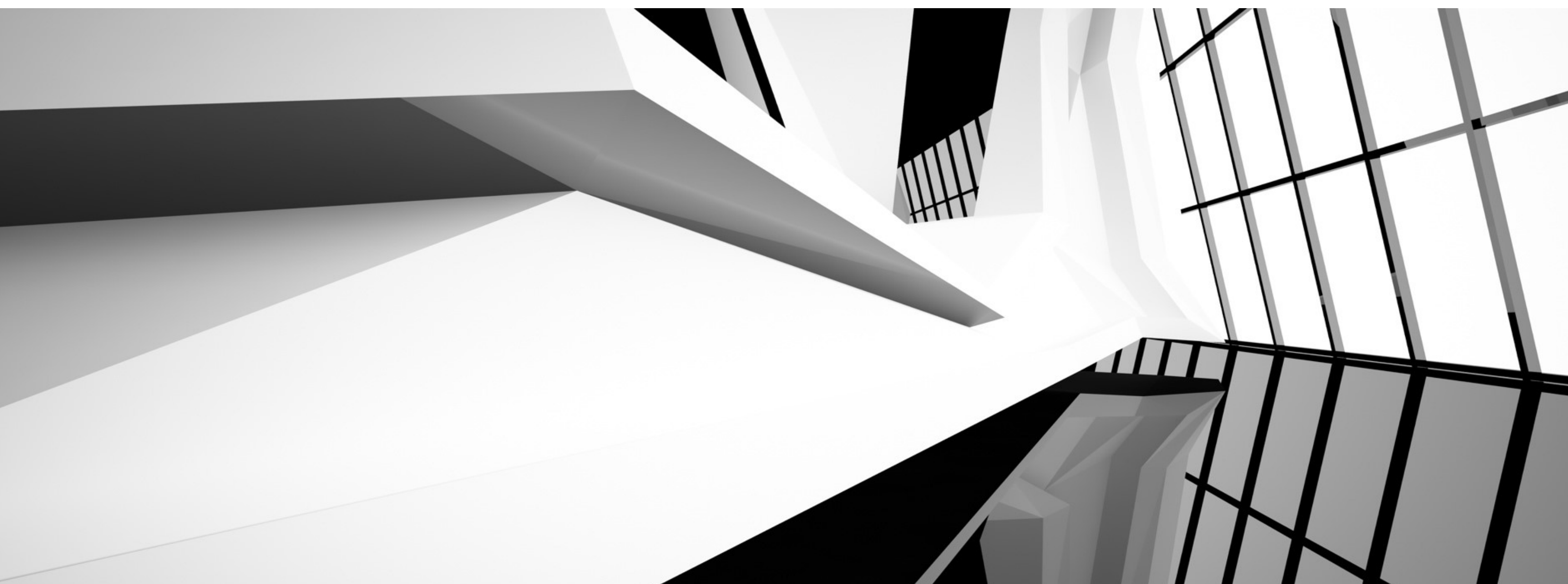
ECJ – German WHT on dividends to nonresident pension funds



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On 13 November 2019, the Court of Justice of the European Union ("**ECJ**" or the "**Court**") issued a decision (C-641/17) whereby the German withholding tax regime applicable to dividends paid to nonresident pension funds is incompatible with the free movement of capital principle of article 63 of the Treaty on the Functioning of the European Union (TFEU). The Fiscal Court of Munich had referred the case to the ECJ on 23 October 2017. The ECJ effectively followed the opinion issued by Advocate General Pikamäe on 5 June 2019.

Background:

In the case at hand, the taxpayer, a Canadian pension fund holding indirect interests of less than 1% of the shares in various German resident companies received dividends. The dividends were subject to a 25% withholding tax (reduced to 15% according to the double tax treaty between Canada and Germany). The fund introduced a request for the refund of the 15% tax withheld. The request was denied by the German tax authorities.

ECJ decision:

The ECJ ruled that Germany's tax treatment was incompatible with EU law on two grounds:

- <u>Free movement of capital</u>

The ECJ concluded that German tax treatment of dividend distributions to pension funds infringed EU law. The court observed that the higher withholding tax burden on a cross-border payment compared to the combined withholding tax and corporate income tax liability resulting from a payment to a domestic pension fund resulted in less advantageous treatment. Indeed both pension funds are subject to two different taxation regime in respect of dividends received. In the case of a non-resident pension fund, the tax on income from capital on such dividends becomes definitive. Conversely, dividends paid to resident pension funds are incorporated in the pension fund's balance sheet, which is subsequently used to determine the taxable profit, on which corporation tax will be charged at the rate of 15%. When that tax becomes payable, the tax on income from capital can be set off in its entirety against the amount due.

As a consequence, non-resident pension funds are treated less favourably than resident pension funds which constitutes a restriction on the free movement of capital. Furthermore, the Court noted that resident and non-resident pension funds are in a comparable situation. the German legislation does not only provide for different tax regimes depending on the residence of the fund, but its application may also lead to the full exemption of the dividends paid to resident funds.The German courts must consider whether the Canadian fund added the dividends received to its pension reserve, either voluntarily or based on Canadian law. If the fund did so, the ECJ stated that there was no justification for the difference in treatment.

The Court then examined whether the restriction can be justified by overriding reasons in the public interest. The Court considered and rejected possible justifications based on the need to ensure a balanced allocation of taxing rights, the need to safeguard the coherence of the German tax system, and the need to ensure the effectiveness of fiscal supervision.

- Standstill clause

This clause allows a derogation from the prohibition on all restrictions existing on December 31, 1993 to the free movement of capital between Member States and third countries, where such capital movements involve direct investment, establishment, the provision of financial services or the admission of securities to capital markets. In the case at hand, the ECJ ruled that since the fund held interests of less than 1% in the German companies, it held a portfolio investment rather than a direct investment and portfolio investments do not fall within the scope of the standstill clause.

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