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Summary

To attain an Internal Market, in which goods, capital and natural and legal persons can move from Member States to Member State, is one of the main aims of the EU. The Treaty of Rome was laid down in order to tear down obstacles that existed and to create bonds between the Member States. The EC Treaty contained the fundamental freedoms, essential in the work towards an Internal Market. In order to attain an Internal Market, tax obstacles, for natural and legal persons, has to be removed. Unless that is done, issues concerning direct tax matters, existing due to the differences between the taxation systems of the Member States, will deter natural and legal persons from establishing themselves or to invest their capital in other Member States. The taxation of cross-border dividends is especially of interest and, as far as direct tax issues are concerned, the freedoms concerning the free movement of capital and the freedom of establishment has been especially important. If the Member States imposes a greater tax burden on outbound or inbound dividend payments as compared to dividend payments made domestically, the establishment of secondary establishments in other Member States and investments by corporations or natural persons in corporations in other Member States will be hindered and the attainment of the Internal Market will be put on hold.

The treatment of cross-border dividend payments within the EU depends on the extent of the holding. For holdings of 10 % or more in the capital of a corporation, subject to other conditions being fulfilled, the preferential treatment of the Parent-Subsidiary directive applies. The directive prescribes that the Member States shall refrain from imposing a withholding tax on outbound dividend payments and to allow inbound dividend payments a relief from double taxation, either by exempting the inbound dividend from tax or at least to allow a credit for foreign corporation tax already paid. The articles prescribing this preferential treatment has been held to have direct effect and thus the weight of the directive has increased. The scope of the directive has also been widened as of late. Despite this, there remain some areas in which clarity is needed. The directive fails to give precedence to either the exemption or the credit method, based on fundamentally different objectives, and amendments has to be considered as regards the method of legislation and the wording of the directive.

The ECJ has had to deal with inbound and outbound dividend payments falling outside the scope of the Parent-Subsidiary directive in numerous cases. The Court has established a clear reasoning as concerns the comparability issue and it demands that the state that has chosen to exercise its taxing jurisdiction in respect of non-residents in a way that makes them comparable to residents has to extend its preferential treatment given to residents also to non-residents. The application of this principle, and other principles adopted as concerns dividend payments, has however not been consistent during the years. This inconsistency is however due to the task and the role of the ECJ, which is to interpret the provisions in the EC Treaty and not to create any new body of law. The ECJ decides the cases brought

before it on a case-by-case method, which result in this inconsistency in its case law. The principles and reasoning applied by the Court is however consistent and the Member States should seek to comply with the provisions in the EC Treaty with the guidance provided by these principles and arguments.

The Court has in its most recent case law made a decision as to which path to trail in the coming years and has chosen to give precedence to taxation by the state of source. It has also indicated that it can't deal with restrictions against the fundamental freedoms when they originate from the parallel application of the different taxation systems of the Member States, which exists due to the inability of the Community legislator to harmonize the legislation of the Member States with the help of legislative acts.

Sammanfattning

Ett av de huvudsakliga målen med den Europeiska Unionen är att uppnå en Inre Marknad, inom vilken varor, kapital och fysiska och legala personer kan röra sig fritt. Romfördraget antogs med målet att ta bort hinder som existerade mellan medlemsstaterna och att skapa band mellan dem. Fördraget innehöll de fyra friheterna, som är av yttersta betydelse i arbetet med att uppnå en Inre Marknad. För att det skall vara möjligt att skapa en Inre Marknad så måste hinder som finns mellan medlemsländerna rörande skattefrågor elimineras. Om inte detta sker så kommer frågor som rör direkta skatter, vilka existerar tack vare de skillnader som finns mellan medlemsstaternas skattesystem att avhålla fysiska och legala personer från att etablera sig eller investera sitt kapital i en annan medlemsstat. Beskattningen av utdelningar som sker över gränserna är av särskilt intresse och de friheter som är av särskilt intresse vad gäller frågor som rör den direkta beskattningen är den fria rörligheten för kapital och den fria etableringsrätten. Om medlemsstaterna inför en hårdare beskattning av inkommande eller utgående utdelningar än för utdelningar som sker inom landet så kommer både fysiska och legala personer att avskräckas från att etablera sig och/eller investera sitt kapital i en annan medlemsstat.

Behandlingen av utdelningar som sker över gränserna inom EU beror på storleken på aktieinnehavet. För innehav över 10 % av kapitalet i ett företag så är den fördelaktiga behandlingen som Moder/Dotterbolagsdirektivet föreskriver tillämpligt, under förutsättningen att övriga villkor för dess tillämpning är uppfyllda. Direktivet föreskriver att medlemsstaterna skall undanta utgående utdelningar från källskatt samt att tillåta att undantag från skatteskyldighet eller möjlighet att avräkna redan betald utländsk skatt medges för inkommande utdelningar. De artiklar som föreskriver denna behandling har av EG-domstolen ansetts ha direkt effekt, vilket kommer att bidra till att direktivet får ökad tyngd. Det bör även noteras att tillämpningsområdet hos direktivet har vidgats under de senaste åren. Det återstår, trots detta, frågor som behöver klargöras. Direktivet ger inte någon av de metoder som är erkända i internationell skatterätt för att undvika internationell dubbelbeskattning, exemption och credit metoden, företräde framför den andre, vilka är baserade på fundamentalt olika synsätt. Dessutom borde ändringar av direktivet övervägas vad gäller lagstiftningsmetoden samt ordalydelsen.

EG-domstolen har fått hantera frågor som rör inkommande och utgående utdelningar som inte faller inom tillämpningsområdet för Moder/Dotterbolagsdirektivet i ett antal fall. När det gäller frågan om jämförbarhet så har domstolen utvecklat ett klart monster över hur den resonerar och den kräver att den stat som har bestämt sig för att utöva sin jurisdiktion vad gäller skatter över personer som inte har hemvist i staten på ett likvärdigt sätt vad gäller personer som har hemvist i staten måste tillerkänna personer som inte har hemvist i staten samma fördelar som de som har hemvist i staten åtnjuter. Tillämpningen av denna princip och av andra principer som EG-domstolen har utvecklat i sin praxis vad gäller frågor gällande in-

kommande och utgående utdelningar, har tyvärr inte alltid varit konsekvent. Detta faktum har dock sin grund i den uppgift och roll som EG-domstolen har, vilken är att tolka reglerna i EG-fördraget och inte att skapa ny rätt. Domstolen avgör de fall som den får hänvisat till sig på en fall-för-fall basis, vilket resulterar i den inkonsekvens som finns i domstolens rättspraxis. Dock är de principer och den argumentation som domstolen använder i dessa fall konsekvent och medlemsstaterna borde söka vägledning av dessa när de skall lagstifta i enlighet med EG-fördraget.

Domstolen har i sin allra senaste rättspraxis fastställt vilken linje som den kommer att följa i framtida mål. Den har slagit fast att den kommer att ge källstatens rätt att beskatta en inkomst företräde framför hemviststaten samt att den inte har möjlighet att ta i tu med restriktioner som existerar tack vare tillämpningen av de olika skattesystemen som medlemsstaterna tillämpar, vilka får fortsätta att existera tack vara oförmågan hos lagstiftaren att harmonisera medlemsstaternas skattesystem vad gäller de direkta skatterna.

Preface

This thesis spells the end of a long journey and it is the culmination of a great experience. As I now conclude my education, there are a few people that I wish to mention.

First of all, I want to thank my family and relatives, who's been a great support throughout this period of time. I also want to thank all of my friends and my classmates during the years for your support, patience, and time and for your belief in my ability.

I also want to thank my supervisor of this thesis, Cécile Brokelind, for providing me with valuable advice and support. The people at the tax department at PriceWaterhouseCoopers in Malmö also deserves a mention, since they made me feel very welcomed and provided me with interesting issues to solve during my time there in February this year.

Malmö
June 8, 2009

Abbreviations

AG	Advocate General
CEN	Capital Export Neutrality
CIN	Capital Import Neutrality
CON	Capital Ownership Neutrality
DTC	Double taxation convention
NN	National Neutrality
NON	National Ownership Neutrality
SEK	The Swedish currency (“svenska kronor”)
The ECJ	The European Court of Justice
The EU	The European Union

1 Introduction

1.1 Background

The thought behind the cooperation between the European states under the name of the European Communities was to create links between the states and thus make them dependant on each other in different areas in order to avoid a new war on this tormented continent.¹ In order to do this, they drafted the treaty of Rome in 1957. The main objectives with the treaty of Rome were to establish a common market and to create a harmonious environment for the development of economic activities throughout the Community.² A number of measures were enacted in order to disintegrate barriers that existed between the economic operators within the Community. Barriers to trade were abolished, a common customs tariff was to be set up and fiscal policies were to be gradually harmonized.³ The treaty of Rome also contained the fundamental freedoms, of which the freedom of establishment and the freedom of movement for capital are especially relevant for corporations. Corporations must be able to establish themselves in other states seamlessly in order to encourage them to stay within Europe and build a strong Internal Market. The free movement of capital is also essential for the corporations. To promote cooperation and integration between corporations in different Member States, provisions that make the movement of capital between corporations resident in two different Member States more difficult than the movement of capital between corporations resident in the same state had to be abolished.

An important issue for corporations seeking to make a secondary establishment, in the legal form of a subsidiary or a branch, in another state is the taxation of that secondary establishment and the taxation of distributions of profits to the parent company. However, the Member States have retained the power to design their own systems of taxation.⁴ Although the Member States have to comply with Community law when exercising this power, the systems of taxation will often be designed with regard to several factors that vary between then Member States.⁵ The Member States are thus likely to have different views on the question of how to tax corporations and the distribution of profits. Some Member may choose to tax the corporations and not the shareholders receiving a distribution of profits, others may choose to do so.⁶ States imposing double taxation on the profits of corporations may further choose to relieve the shareholders receiving a distribution of profits from the double taxation created or not to do so.⁷ This might not give rise to problems in situations of a wholly internal nature, but when dis-

¹ Craig/De Búrca (2008), pp. 3-6

² Craig/De Búrca (2008), p. 6

³ Ibid.

⁴ Terra/Wattel (2008), p .29

⁵ Terra/Wattel (2008), pp .29-30

⁶ Chapter 3

⁷ Ibid.

tributions of profits are made cross-border, the situation might be different. The application of different systems of taxation and the fact that states generally exercises its taxing jurisdiction based on two different connecting factors, residence and source, might lead to a heavier taxation of cross-border distributions of profits compared to distributions in a wholly internal situation.⁸ Such a situation creates a restriction on the freedom of establishment and the free movement of capital, since corporations might be deterred from establishing themselves in another Member State.

However, it is not only corporations that might be subject to double taxation. Natural persons resident in one Member State but receiving dividend income from another may first be subject to tax in state from which the dividend payment is made and second in the state in which the person receives the dividend. This hinders the attainment of the Internal Market and thus such restrictions have to be removed, in order for the Internal Market to function properly.

Thus, the treatment of distributions of profits within the Community is of great importance to achieve the goal of a common market. The cooperation between corporations in the different Member States might be hindered if corporations cannot compete and operate cross-border on the same terms, as they are able to do in a wholly internal situation. Individuals might be dissuaded from investing their capital abroad, even though it might be more profitable, due to tax issues. Therefore, the proper functioning of the fundamental freedoms has to be upheld, both by the legislature and the ECJ, in respect of distributions of profits cross-border.

1.2 Problem

One of the main objectives with the cooperation between the Member States in the European Community are, as seen above, to create a common market. The fundamental freedoms and their application as regards taxation are of great importance if the common market is to be achieved. The taxation of distributions of profit is especially of interest here, since it concerns investments made by individuals and corporations. The proper functioning of the common market will be threatened if persons, legal or natural, are deterred from investing their capital or establish themselves in another Member State due to differences in tax treatment. With regard to this and the fact that the principle of legal certainty is of especial importance in the field of direct taxation, this thesis seeks to examine the treatment of distributions of profit in EC direct tax law. The problem thus to be examined in this thesis is the search for consistency in the treatment of distributions of profit within the European Community. Does it exist and, if it does, can it be said to adhere to any theory aspiring to achieve neutrality in the international tax system and how does it compare to the treatment under the OECD model convention?

⁸ Chapter 2

1.3 Purpose

The purpose of this thesis is to establish how cross-border dividend payments within the EU are treated within the EU, both payments subject to the preferential treatment prescribed in the Parent-Subsidiary directive and payments falling outside of the scope of the directive, to which the fundamental freedoms in the EC Treaty is applicable. I will seek to establish the treatment of dividend payments and then compare it to treatment of dividends provided for by the OECD model convention on double taxation and compare it to two of the main theories that aspire to achieve neutrality in international taxation. The purpose of this is to compare the treatment in the EU with the treatment in international tax law and basic economic theory. As regards the chapter on the case law of the ECJ concerning dividend payments outside the scope of the Parent-Subsidiary directive is to first, establish how the Court deal with inbound and outbound dividend payments in the light of the fundamental freedoms in the EC Treaty and second, to see if the case law is consistent and determine the principles and argumentation that the Court adheres to when deciding cases concerning outbound and inbound dividend payments.

1.4 Disposition

In the first chapter, I will introduce the thesis by giving the reader a background to the problem and then describe the purpose, method, material, outline and delimitation of the thesis. After this, I will move on to the second chapter, in which I will introduce the concept of double taxation. In the third chapter I will present the concept of neutrality in taxation systems and give the reader some examples of theories that aspire to achieve neutrality. In the fourth chapter, I will present different examples of taxation systems and describe how these systems treat dividend payments. This will be done in order to give the reader an overview of how the treatment of dividend payments can vary between the Member States of the EU due to the application of different taxation systems and to give a better understanding of the case law of the ECJ presented later in the thesis.

In the fourth chapter, which will constitute the biggest part of the thesis, a presentation of the treatment of dividend payments under EC law will be made. The presentation will be, for simplification reasons, divided into two different categories. First, a presentation will be made of the treatment of distributions of profit under the Council directive 90/435 of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (hereinafter referred to as the Parent-Subsidiary directive) and second, a presentation of the case law produced by the ECJ when dealing with distributions of profit in the light of the freedom of establishment and the free movement of capital.

After this, I will move on to presentation of the treatment of dividend payments in the OECD Model convention on the prevention of double taxation. In this part, I will mainly deal with the 10th article of the model convention, as it deals with the relevant subject. Presentation of the relevant

parts of the commentaries to the model convention and doctrine will also be made.

The thesis will be concluded in the two final chapters, which is of an analyzing character. There I will present my conclusions regarding the treatment of dividend payments within EC law and in the OECD model convention and compare the two areas to each other and with the neutrality concepts presented earlier in the thesis. The thesis will be concluded with my final thoughts on the subject matter.

1.5 Delimitation

The thesis will only deal with the problem concerned from mainly three perspectives. First, the problem will be considered in the context of the thought that international tax systems should be neutral. Within this section, only the theories of Capital Export Neutrality and Capital Import Neutrality will be dealt with in-depth. However, other theories will be presented briefly. Second, the problem will be considered in the context of EC law. Within this section, the problem will be considered in first, the light of the case law produced by the ECJ when dealing with distributions of profit in the light of the fundamental freedoms and second, the light of the Parent-Subsidiary-directive. Third, the problem will be considered in the context of the Model convention on the elimination of double taxation from the OECD. The assessment of the model convention will be limited to the parts of the model convention that are of interest for this thesis, namely those that deal with the allocation of taxation jurisdiction with regard to dividends and the two method articles contained within the model convention. The presentation of how the model convention deals with the allocation of the right to tax and the elimination of international double taxation will then be compared to how these issues is treated within EC law, both in the Parent-Subsidiary directive and in the case law shaped by the ECJ.

1.6 Method and material

The method used in this thesis is dependant on the material that is necessary in order to investigate the subject matter. As can be inferred from the above stated, this thesis will be largely dependant on the case law of the ECJ. However, other sources of legal material will be considered, e.g. doctrine from legal writers, articles and commentaries. The material will consist mainly of sources that deal with EC and international tax law.

The method used will be a traditional legal dogmatic method. The method consists of a review and analysis of relevant legal documents such as case law, legal writing, statutory acts etc.⁹ As mentioned above, this thesis will be based on a review and analysis of mainly EC tax law sources, but also international tax law material, such as the OECD model convention on double taxation and the commentaries, as well as legal writing, will be considered.

⁹ Peczenik (1995), pp. 33 and 35-44

The cases that will be examined in the case law chapter concerns the assessment of the legislation of the concerned Member State and its compatibility with the provisions in the EC Treaty concerning the fundamental freedoms, especially the freedom of establishment and the free movement of capital. These cases deal with dividend payments in respect of holdings of shares that do not qualify for the preferential treatment prescribed by the Parent-Subsidiary directive. It is therefore of interest to assess these cases in order to determine which treatment the Member States have to confer to outbound and inbound dividend payments within the EU as compared to wholly internal payments under the free movement provisions in the EC Treaty. By doing so, a complete picture of the treatment of dividend payments within the EU will be given, both for holdings inside and outside the scope of the Parent-Subsidiary directive.

I have been able to consider all relevant sources of material for this thesis up to 5 May 2009.

2 Double taxation

2.1 Overview

A distinction has to be made between two different forms of international double taxation, juridical and economical. International juridical double taxation is usually defined as “the imposition of comparable taxes in two (or more) states on the same taxpayer in respect of the same subject matter and for identical periods”.¹⁰ On the contrary, international economical double taxation is defined as the imposition of comparable taxes in two or more states on the same subject matter, but in respect of two different taxpayers.¹¹

Then, why does double taxation exist? In principle, there are two principles that define the taxing jurisdiction, the residence and the source principle. These two principles serve as connecting factors and attributes taxing jurisdiction to a certain state. To divide jurisdiction by source is a direct method of attribution, whereas residence is an indirect method.¹² The method of attributing taxing jurisdiction by residence is indirect because it does not look directly at the economic activity that produced the income, but rather at the person or entity that is the taxpayer.¹³ It is based on the relationship between this person or entity, in contrast to the source method, which seeks to place a given transaction or activity giving rise to the income within a particular state.¹⁴

With these two connecting factors, there is an obvious risk that conflicts will arise. The conflicts will arise due to the fact that different jurisdictions may be claiming the right to tax the same income (so-called international juridical double taxation). However, of greater interest as far as this thesis is concerned, is the situation when two jurisdictions is taxing the same income, but in respect to two different taxpayers and taxes (international economical double taxation). These conflicts may arise between source states, between residence states or between states, which applies one of these principles but not the same as the other. The most important of these possible conflicts is the one between source and residence states.¹⁵ When such conflicts arise, then the starting point in international tax law is so-called source state entitlement, which requires the state of residence to prevent double taxation by either exempting foreign-sourced income (CIN) or crediting the foreign tax paid (CEN).¹⁶ This approach has become a fundamental principle in international tax law.¹⁷

¹⁰ Dahlberg (2007), p. 24

¹¹ Dahlberg (2007), p. 25

¹² Barker (2002), p. 181

¹³ Ibid.

¹⁴ Ibid.

¹⁵ Barker (2002), pp. 181-182

¹⁶ OECD Model, art. 23 A and B; Graetz/Warren (2007), p. 1589, footnote 32; Terra/Wattel (2008), pp. 170 and 172

¹⁷ Barker (2002), p. 182

The principles are in principle neutral but they are not applied neutrally. Usually, the residence principle is only applied to residents and not to non-residents and the source principle is usually applied only to non-residents.¹⁸ If the goal is true neutrality, then worldwide taxation, as follows from the residence principle, should be applied to both residents and non-residents (with prevention of double taxation as for residents) or a strict territoriality system should be applied (disregarding foreign-source income and losses) for both residents and non-residents.¹⁹

Finally, one should mention the fact that there is no rule in EC law on the question of which of the two states should prevent double taxation and no rule on the prevention of intra-EC double taxation.²⁰ One may not however disregard article 293 EC, which stipulates that the Member States should enter negotiations with each other in order to abolish double taxation within the Community insofar as necessary.

Another interesting issue is whether it exists an obligation under the EC Treaty for the Member States to avoid double taxation. The view that there is such an obligation is supported by articles 293 and 10 EC, which requires the Member States to enter into negotiations with the view to abolish double taxation and to act in loyalty towards the Community respectively. The Commission is of the opinion that these two articles read in conjunction with each other establishes such an obligation.²¹ Some issues have however risen due to the wording “as so far it is necessary”, contained within article 293 EC.²² The ECJ has not explicitly stated that double taxation in itself is a breach of the EC Treaty, but it has held that article 293 EC includes an objective to eliminate double taxation.²³ It is however not possible to infer from this that there is no obligation to avoid double taxation and the ECJ is yet to decide whether this objective is contained within any other of the articles in the EC Treaty.²⁴ It has however been argued that the objective of eliminating double taxation within the Community is not exclusively based on article 293 EC.²⁵

2.2 Comments

This chapter has provided an overview of the concept of international double taxation. It is essential to understand the concept of international double taxation, as this thesis concerns issue arising due to the existence of economic double taxation of distributions of profit within the EC.

There are two different kinds of international double taxation, juridical and economic double taxation. International double taxation exists due to the application of two different connecting factors, which are neutral in principle, but usually not applied neutrally. We have seen that the starting

¹⁸ Terra/Wattel (2008), p. 170

¹⁹ Ibid.

²⁰ Ibid.

²¹ SEC (2001) 1681, p. 284; Lehner in Lang et al. (eds.) (2007), pp. 14-15

²² Lehner in Lang et al. (eds.) (2007), p. 14

²³ Hofstätter in Lang et al. (eds.) (2007), pp. 27-28

²⁴ Hofstätter in Lang et al. (eds.) (2007), p. 28

²⁵ Hofstätter in Lang et al. (eds.) (2007), pp. 28-29

point in international tax law when double taxation arises is so-called source-state entitlement, requiring the state of residence to undo the double taxation. We have also seen that there is a possibility that an obligation to avoid double taxation in the EC Treaty exists.

In the next chapter, a presentation will be made on different types of taxation systems. This will provide an exemplification on how the connecting factors presented in this chapter can be applied and of how the domestic legislation in the states deals with international economic and juridical double taxation. It will also provide an overview of the different views existing on the taxation of corporation profit, both at corporation and at shareholder level.

3 Different systems of taxation

3.1 Overview

When a company makes a distribution of profit (e.g. in the form of a dividend), that distribution will, in general, be subject to income tax both at corporation level and at shareholder level. This creates a risk that the profits of the corporation will be subject to tax both when it arises and when it is distributed. The question that arises for the states to answer is whether, and if so, how, to eliminate this double taxation.²⁶ If the state chooses to do so, two possibilities exist, either to eliminate it at corporate level or at shareholder level.²⁷ At corporate level, the elimination may consist of a possibility for the corporations to deduct dividends or to adopt a tax system that favours the distribution of profits.²⁸ At shareholder level, then the elimination may take the form of granting the shareholder a credit for the income tax already paid by the company or by granting dividend payments a preferential treatment as compared to other forms of income.²⁹

The two main oppositional methods are the classical system and the integration system. In a classical system, the tax paid by the corporation is not integrated into the tax payable by the individual shareholder, thus the system does not eliminate double taxation.³⁰ The opposite of the classical system is the integration system, which integrates both of the taxes, most significantly in a so-called imputation system.³¹ In between these two opposites there are other systems that have features in common with either the classical system or the integrations system.

Under a classical system, the profits of the companies is taxed with corporate income tax, irrespective if they are retained within the company or distributed.³² If the profit of the company were distributed, then the distribution of profit would be subject to income tax at shareholder level.³³ The application of such a system will result in double taxation. However, there is often some form of exemption for corporate shareholders of some significance, usually only applicable if the company owns a certain percentage of the shares (so-called portfolio holdings).³⁴ Some states have even introduced the possibility for corporations to consolidate their income and tax it as a group.³⁵

However, there aren't many classical systems in its purest form. States can, for example, distinguish between dividend income and other income of

²⁶ Terra/Wattel (2008), p. 180; Graetz/Warren (2007), p. 1579

²⁷ Jacobs (1999), p. 265

²⁸ Ibid.

²⁹ Ibid.

³⁰ Terra/Wattel (2008), p. 180; Helminen (1999), p. 21; Jacobs (1999), p. 265

³¹ Ibid.

³² Terra/Wattel (2008), p. 181

³³ Ibid.

³⁴ Ibid.

³⁵ Graetz/Warren (2007), p. 1580

individual shareholders and then tax the dividend income at a rate that is lower than the normal income tax rate.³⁶ The same effect may also be achieved by reducing the taxable base instead of the tax rate, i.e. only include a certain percentage of the distribution of profit in the taxable base of the shareholder.³⁷

Another option is to provide full relief from double economic taxation at either corporate or shareholder level. This can be done at shareholder level by providing for a total exemption from individual income taxation for the dividends received.³⁸ At corporate level, this is achieved if retained profits are taxed, either by allowing a deduction of the corporate tax already levied from the profit distribution or by allowing a refund of the corporate income tax already levied upon distribution of the profits.³⁹ Another option, applied by Estonia, is to not levy a corporate tax at all and then levy a final withholding tax when the profits are distributed.⁴⁰ Since there is no tax for retained profits, no double taxation will occur; under such a system, however, the rate of the withholding tax needs to be high.⁴¹ If a state wants to have taxation at two levels, then that state can first tax the profits of the corporations with a corporation income tax and then, when the company distributes its profits, levy a final withholding tax. This system is very easy and effective as it integrates two levels of taxation to one and is also very effective from an administrative point of view.⁴²

The opposite of classical systems is integration systems. Under these systems you integrate the two levels of taxation by granting a full or partial credit at shareholder level for the corporate income tax paid with respect to the profit distributed.⁴³ This kind of integration system is called an imputation system and this is the most intricate integration system.⁴⁴ In such a system, the corporate income tax functions as a withholding tax, which is creditable against the personal income tax.⁴⁵ The credit that is available to the shareholder is called an imputation credit. This credit may be expressed in different ways. First of all, a distinction has to be made on the basis of how much of the corporate income tax that is being credited. The credit can be either partial or full. If the credit is partial, then the credit may be expressed as either a percentage of the net dividend received by the shareholder (also applicable to a full credit, depending on the percentage) or as a percentage of the underlying corporate income tax.⁴⁶ As for the full credit, the credit may be expressed as stated above or it may be equal to the underlying corporate income tax.⁴⁷ States applying an imputation system may have to levy

³⁶ Terra/Wattel (2008), p. 182

³⁷ Ibid.

³⁸ Ibid.

³⁹ Ibid.

⁴⁰ Ibid.

⁴¹ Ibid.

⁴² Terra/Wattel (2008), p. 184

⁴³ Graetz/Warren (2007), p. 1579; Jacobs (1999), p. 266

⁴⁴ Terra/Wattel (2008), p. 184

⁴⁵ Terra/Wattel (2008), p. 184; Graetz/Warren (2007), p. 1579

⁴⁶ Terra/Wattel (2008), p. 184

⁴⁷ Ibid.

a compensatory tax in order to avoid the granting of a credit for distributions of profit on which no corporate income tax has been levied.⁴⁸

The choice among these options, in order to shape the domestic tax policy of the state, will depend on several factors. These factors may be, inter alia, the state's view on the economic effects of taxing income from corporations more heavily than capital income, compliance burdens of the different alternatives and the relationship between corporate and individual tax rates.⁴⁹

3.2 Comments

This chapter has provided an overview on different taxation systems that exists. This has been done in order to provide a background to have in mind when the treatment of outbound and inbound dividend payments is considered in the light of the Parent-Subsidiary directive and, mainly, to be able to better understand the sometimes very complex case law of the ECJ.

The two main opposites are the classical and the imputation systems, but there aren't many of these two systems existing in their purest form. A presentation has also been made of other ways of designing a taxation system. It has also shown that there are different views on how to tax the profit of corporations and of how to deal with economic double taxation within the state.

In the next the chapter, a presentation will be made of the concept that the international tax system should be designed neutrally and of different theories that advocates different methods to achieve it. The perspective will thus change, from a domestic perspective, where we have looked at the concept of international double taxation that might arise when dividends are made cross-border and the design of the domestic tax systems when dealing with distributions of profit of corporations, to a international perspective, where the concept of tax neutrality will be assessed in a international context.

⁴⁸ Graetz/Warren (2007), pp. 1579-1580

⁴⁹ Ibid.

4 Neutrality in taxation systems

4.1 Theories concerning neutrality in taxation systems

4.1.1 Introduction

One of the fundamentals of the cooperation between the European states is the freedom for economic operators in the different Member States of the EU to interact with each other in accordance with the fundamental freedoms as laid down by the EC Treaty. In this regard, the freedom of establishment and the freedom of movement of capital are of particular interest. In order to fulfil the aim of free movement of capital, the taxation system of the different Member States have to be non-discriminatory in the sense that they treat nationals and non-nationals in the same way if they are in a comparable situation. The system of taxation should not be decisive for the economic operators in their choice of which operations to perform, their decisions should rather be based on factors other than fiscal.⁵⁰ That is however not the case in practise, as taxation as such is non-neutral in many respects.⁵¹ It is also important to remember that the theories presented below is economic theories, which aspires to achieve efficiency in the international economy and economic efficiency will be promoted if the international tax system is neutral.⁵² However, taxation is a powerful tool to use by the politicians of the states to create incentives and thus it will be used to create such incentives, not to achieve efficiency in the international tax system.

The aim to achieve by striving against international tax neutrality is economic efficiency.⁵³ The thought is that if the economic efficiency is maximised, it will result in maximum wellbeing in overall terms.⁵⁴ The theories that have as an objective to lead to international tax neutrality seeks to keep investments and business decisions unaffected by the imposition of taxes.⁵⁵

The two main theories that aspire to achieve neutrality in international taxation are Capital Import Neutrality (CIN) and Capital Export Neutrality (CEN).⁵⁶ These two theories are not compatible with each other; they cannot exist side by side unless the tax rates and bases are identical in the

⁵⁰ Ståhl (1996), p. 89; Helminen (1999), p. 11

⁵¹ Helminen (1999), p. 11

⁵² See next paragraph

⁵³ Shaheen (2007), p. 206; Barker (2002), p. 188

⁵⁴ Shaheen (2007), p. 206

⁵⁵ Shaheen (2007), p. 207

⁵⁶ Presented in chapter 3.1.2 and 3.1.3; the principles were introduced by Peggy B. Musgrave in "United States taxation of Foreign Investment Income" (1963) and "Taxation of Foreign Investment Income – An Economic analysis" (1969), see Shaheen (2007), footnote 2

state of residence and in the state of source.⁵⁷ Some commentators have claimed that the inconsistencies in the case law of the ECJ (as they see it) stems from the fact that the Court tries to eliminate double taxation with the application of both theories.⁵⁸ It should however be noticed at this point that there are other theories that aspire to achieve international tax neutrality. These are the theories of national neutrality (NN), capital ownership neutrality (CON) and national ownership neutrality (NON).⁵⁹

4.1.2 Capital Import Neutrality (CIN)

The theory of Capital Import Neutrality (CIN) considers that all activity within one state should bear the same tax burden, whether the capital used in the production within the state is domestic or foreign.⁶⁰ This means that the state of residence should exempt foreign-sourced income of its nationals, as that income has already borne tax in the state of source.⁶¹ The theory in its classical form seeks neutrality with respect to business competition and expansion opportunity within each state that imports capital and thus calls on the states to adopt a source-based taxation.⁶²

One of the main objectives behind this theory is neutrality in competition, in the sense that different investors should be able to compete on a level playing field within the same market.⁶³ If, for example, CIN would be applicable to investments made in state A, then companies from state A, B and C will be given the same chance to compete tax-wise when they invest in state A.⁶⁴ Another objective for the theory is that if all investments within the same jurisdiction are taxed only at source and only by this jurisdiction, regardless of the residency of the investors, then taxation will have no effect on business competition and expansion opportunities within each one of the concerned jurisdictions.⁶⁵ Therefore, in theory and if investors are considered to be rational, the application of CIN will result in that the profit after taxes in the states are levelled out.⁶⁶ As long as the profit after taxes are different in different states, then the investors will locate their investments to states in which their investment will be rewarded with the highest net profit and the incentives to save instead of consuming will eventually be the same in all states.⁶⁷ Another argument for the theory of CIN is that it increases economic welfare by encouraging the most efficient use of resources within one state.⁶⁸

⁵⁷ Terra/Wattel (2008), p. 169; Graetz (2001), p. 5; Graetz/Warren (2007), p. 1582 and Shaheen (2007), p. 212

⁵⁸ Graetz/Warren (2006), p. 1253

⁵⁹ Shaheen (2007), p. 205

⁶⁰ Graetz/Warren (2007), p. 1582

⁶¹ Terra/Wattel (2008), p. 174

⁶² Shaheen (2007), p. 210

⁶³ Ståhl (1996), p. 104

⁶⁴ Ibid.

⁶⁵ Shaheen (2007), p. 210

⁶⁶ Ståhl (1996), p. 105

⁶⁷ Ståhl (1996), p. 105 and Shaheen (2007), p. 211

⁶⁸ Graetz/Warren (2007), p. 1582

To achieve CIN, the state of source must have the right to tax all income within its jurisdiction, the tax law of the state of source should not discriminate between domestic and foreign investors and the state of residence will have to grant a full exemption for foreign income.⁶⁹ Ståhl considers that the theory of CIN cannot be achieved with the application of the exemption with progression method or the credit method.⁷⁰ Terra and Wattel however considers that this is possible.⁷¹ They believe that states adhering to the CIN theory can choose to relieve their residents with the usage of either full exemption or exemption with progression, with the main difference being that with the latter, since both foreign losses and profits are included in the taxable base, but only to determine the applicable tax bracket on the domestic income, will provide for an automatic cross-border horizontal loss relief.⁷²

One of the positive effects that the application of CIN is said to have is that it provides tax neutrality for savings and results in an effective allocation of savings.⁷³ Another can be that it can reduce the segregation of the national stock markets.⁷⁴ There will not be any need to impose tax-sparing credits since tax efficiency and incentives in the state of source will benefit the foreign investor rather than the Treasury of the home state, as is the case if a credit system is applied.⁷⁵ A drawback with an exemption system is however that it is vulnerable to both fair and unfair tax competition, resulting in a need to adopt legislation combating this kind of behaviour, e.g. CFC-legislation.⁷⁶

4.1.3 Capital Export Neutrality (CEN)

The theory of Capital Export Neutrality calls for the residence state to tax foreign-sourced income in a way that neither encourages nor discourages residents to invest abroad.⁷⁷ All income earned by the residents of the state should bear the same income tax burden, no matter if the income is earned at home or abroad.⁷⁸ Neutrality in the view of CEN is achieved when decisions to invest in the home state or in another state will not be affected by the taxation because the tax incidence will be the same.⁷⁹

The theory of CEN is traditionally said to be supporting residence-based taxation.⁸⁰ This however does not mean that the home state has to receive any tax and the theory is satisfied if the host state applies the same

⁶⁹ Ståhl (1996), p. 106; see also Shaheen (2007), p. 212 and Graetz/Warren (2007), p. 1582

⁷⁰ Ibid.

⁷¹ Terra/Wattel (2008), p. 174

⁷² Terra/Wattel (2008), pp. 174-175

⁷³ Shaheen (2007), p. 211; Ståhl (1996), p. 104; Barker (2002), p. 189

⁷⁴ Ståhl (1996), p. 105

⁷⁵ Terra/Wattel (2008), p. 175

⁷⁶ Ibid.

⁷⁷ Terra/Wattel (2008), p. 172

⁷⁸ Graetz/ Warren (2007), p. 1582; Barker (2002), p. 189

⁷⁹ Barker (2002), p. 189

⁸⁰ Barker (2002), p. 189; Graetz/Warren (2007), p. 1582; Terra/Wattel (2008), p. 172; Ståhl (1996), p. 94

tax rate for the income, as it would have done if the home state had been the only taxing jurisdiction.⁸¹

The rationale for states adhering to this theory is that decisions about where to invest should not be affected by taxation and thus the invested capital should be subject to the same tax rate. A taxpayer is therefore taxed in his home state for his worldwide income, including income that is sourced in a foreign state; however, he will be able to credit the foreign tax already paid against the tax paid on the home state income.⁸² If the tax rate in the state of source is lower than the tax rate in the home state, then the home state will subject the income to the tax rate constituting the difference between the two tax rates.⁸³ In the opposite situation, when the tax rate of the state of source is higher than in the home state, then a consistent application of the theory of CEN would demand the home state to refund excess foreign tax. In such situations, most states adhering to CEN will abandon this theory and tax the income according to CIN; the states limits the tax creditable to domestic tax attributable to foreign source income (so-called ordinary credit).⁸⁴ According to Ståhl, the theory can only be attainable if the method of full credit is applied and not with the above-mentioned method of ordinary credit, unless specific conditions apply.⁸⁵

Ståhl describes different ways of attaining CEN. One way is to introduce pure residence-state taxation, meaning taxation of the profit from international investments in the state of residence.⁸⁶ To wholly eliminate the taxation in the state of source is not realistic, nor is it necessary. It is possible to combine the theory of CEN with withholding taxes according to Ståhl, but certain conditions must be fulfilled. The theory demands that the foreign income is taxed in the home state, that the tax rules of the home state applies to foreign income in the same way as to domestic income (both tax rates and tax base has to be the same) and the home state has to give full credit for the foreign taxes paid.⁸⁷

Terra and Wattel point to different complications with the application of a credit system. If a tax payer has a negative foreign source income, then normally this will be included in total income and thus result in a set-off of the foreign loss against the domestic tax, thus reducing the tax; if in the following years positive foreign income is made, then the tax lost in the previous years will have to be “recaptured“ before any credits can be given.⁸⁸ In the opposite situation, when there is a home state loss, then no credit is possible since no domestic tax is due; in order to carry over unused foreign tax credit to previous or later years, then a mechanism for this has to be introduced.⁸⁹ Further, a tax-sparing credit can have to be introduced in order to

⁸¹ Barker (2002), p. 189

⁸² Terra/Wattel (2008), p. 172

⁸³ Ibid.

⁸⁴ Ibid.

⁸⁵ Ståhl (1996), p. 95

⁸⁶ Ståhl (1996), p. 94

⁸⁷ Ståhl (1996), p. 95

⁸⁸ Terra/Wattel (2008), p. 173

⁸⁹ Ibid.

avoid certain effects when other states introduce temporary exemption from tax or a specific tax reduction in order to attract international investment.⁹⁰

4.1.4 Other theories

As previously mentioned, there are other theories about how to achieve neutrality in the taxation systems. One of them is the theory on Capital Ownership Neutrality (CON). CON demands that different ownership patterns, not the allocation of capital, should be free of distortions, which is a result of the taxation system.⁹¹ Under this theory, if the efficient allocation of capital is believed to lead to maximization of the productivity, then the most efficient taxation system must be the one that encourages the most productive ownership of capital.⁹² Thus, the potential gain from moving the ownership to an owner that offers a higher productivity must be exactly equal to the moving of the ownership by offsetting ownership changes elsewhere.⁹³ In order to achieve CON, conformity among all states is needed, which means that they must all adopt either source- or residence-based taxation systems.⁹⁴

The objective of the theories of National Ownership Neutrality (NON) and National Neutrality (NN) is the same, to maximize national efficiency.⁹⁵ Under NN, both residence and source state can tax capital, which will lead to international double taxation.⁹⁶ Thus, NN will be satisfied when foreign source income of the states' residents is subject to national tax with a deduction for foreign taxes available.⁹⁷ Residence-based taxation will be promoted if the theory of NN is applied, since it penalizes the exporting owner of the capital.⁹⁸ On the other hand, the theory of NON seeks to exploit the tax differentials that exist in order to maximize national efficiency.⁹⁹ This theory encourages nationals to make outbound investments in situations when the after tax return is higher on such an investment than the after-tax return for similar domestic investments.¹⁰⁰ This is based on the assumption that foreign inbound investments will substitute for any national outbound investment and therefore compensate for the loss on national outbound investments.¹⁰¹ The theory of NON is satisfied if source-based taxation is applied together with an exemption of foreign-sourced income from the taxation in the residence state.¹⁰²

⁹⁰ Terra/Wattel (2008), p. 174

⁹¹ Shaheen (2007), p. 208

⁹² Shaheen (2007), p. 209

⁹³ Kane (2006), p. 57

⁹⁴ Shaheen (2007), p. 209

⁹⁵ Ibid.

⁹⁶ Barker (2002), p. 190

⁹⁷ Shaheen (2007), pp. 209-210

⁹⁸ Barker (2002), p. 190

⁹⁹ Shaheen (2007), p. 210

¹⁰⁰ Ibid.

¹⁰¹ Ibid.

¹⁰² Ibid.

4.2 Comments

This chapter has presented some of the theories that aspire to achieve neutrality in the international taxation system. It has provided an overview of the two main theories on the subject matter, which will be discussed and compared to the conclusions made on the treatment of dividend payments under the Parent-Subsidiary directive and under the EC Treaty provisions.

Two of the theories have been presented in a more detailed manner than the others, because these two are considered to be the two main theories in international taxation. It has been shown that the two theories are linked to a method that deals with the elimination of international double taxation, the exemption and the credit method. The exemption method is linked to the CIN theory and the credit method to the CEN theory. This is worth a thought when the thesis deals with the Parent-Subsidiary directive, the case law from the ECJ and the OECD model convention on double taxation.

It must once more be stressed that the theories presented above is economic theories that aspires to achieve economic efficiency by keeping the international tax system neutral. Taxes are however a powerful tool to use to create incentives and it will first and foremost be used to do so.

5 EC law

5.1 Introduction

5.1.1 General remarks

There aren't many provisions in the EC Treaty concerning direct taxes; they are not even mentioned as such in the treaty.¹⁰³ The legal basis for integration in the field of direct taxation is relatively small, the only rule available in reality being article 94 EC.¹⁰⁴ That article deals with the approximation of laws that directly affects the establishment and functioning of the common market and, most importantly, it requires unanimous decision taking.¹⁰⁵ The article also requires a proposal from the Commission in order for the Council to be able to adopt a measure.¹⁰⁶

An important aspect is that, because article 95 EC is not applicable, the only legally binding instrument available in the harmonization of direct taxes is a directive. Thus, the more powerful instrument, regulations (binding on and directly applicable in all Member States), is not available.¹⁰⁷ Directives are only binding as to the end to be achieved while leaving it to the Member States to choose how to address the issue and they do not have to be addressed to all of the Member States.¹⁰⁸ Taking all these circumstances together, one may conclude that the legal integration in matters concerning direct taxation is hampered by the fact that all of the Member States have the power to veto any measure proposed by the Commission and when the Member States agree on something, the only measure available is the legal instrument of a directive, which is not as powerful and does not lead to as deep and fast approximation of the laws of the Member States as the legal instrument of regulations. However, one may not forget that the Council has adopted four directives concerning direct tax-matters and the soft law shaped by the Commission (see below).

5.1.2 The work of the Commission

The contribution to the harmonization of the Member States' direct tax laws by the legislature has been small, mainly due to the requirement of unanimity and thus, the harmonization by the adoption of legally binding acts (positive integration) is moving forward at a slow pace.¹⁰⁹ The importance of so-called negative integration (the case law shaped by the ECJ and the work by the Commission) has increased. The recommendations and communications issued by the Commission have proven to be quite effective,

¹⁰³ Terra/Wattel (2008), p. 18; Dahlberg (2007), p. 217

¹⁰⁴ Terra/Wattel (2008), pp. 18-19

¹⁰⁵ Terra/Wattel (2008), p. 19

¹⁰⁶ Ibid.

¹⁰⁷ Craig/De Búrca (2008), p. 83

¹⁰⁸ Craig/De Búrca (2008), p. 85

¹⁰⁹ Terra/Wattel (2008), p. 168

most so in the areas supported by legally binding acts and the case law of the ECJ.¹¹⁰

In 1992, the Commission appointed a committee that were given the task to examine different issues arising from the differences in taxation between the Member States (“the Ruding committee”).¹¹¹ The committee concluded that the differences in taxation between the Member States gave rise to distortions in the Internal Market for goods and capital.¹¹² Different measures were proposed by the committee and they dealt with first, the elimination of the double taxation of cross-border income flows and second, the approximation of corporation taxes.¹¹³ The Commission has later concluded that the findings of the committee did not lead to any significant progression.¹¹⁴

Two recommendations were issued by the Commission in 1994, one concerning the taxation of small and medium sized corporations and the other the taxation of non-resident individuals.¹¹⁵ The latter may have inspired the Court in *Schumacker* (C-279/93), whereas the first one did not prove to be equally effective.¹¹⁶

The Commission adopted two communications in 2001, in which it laid down the strategy for the work to be done in the following years. It stated that the work should be aimed at increasing the cross-border activity among corporations by the removal of tax obstacles and at the removal of double taxation of personal income.¹¹⁷ Measures to tackle these issues were discussed, but also the role of the Commission itself. The conclusion was that the Commission should adopt a more pro-active role and, e.g. use the tool of infringements proceedings more frequently and to provide guidelines on the case law of the ECJ.¹¹⁸ The measures to be taken were split up into two sub-categories, targeted measures and a comprehensive solution. The targeted measures included, inter alia, the amendment of the Parent-Subsidiary directive and to provide guidelines on the case law of the ECJ, whereas the comprehensive solution was to work towards a consolidated corporate tax base within the EU.¹¹⁹

In 2003, two more communications were released, one regarding company taxation and the other the taxation of dividends in respect of individuals.¹²⁰ In the first communication, the Commission presented the progress made with the targeted measures presented in 2001 and it continued to stress the importance of a consolidated tax base for corporations.¹²¹ The Commission was also of the opinion that the two-track strategy laid down in

¹¹⁰ Craig/De Búrca (2008), pp. 86-87; Terra/Wattel (2008), pp. 19-20 and 197

¹¹¹ Report of the Committee of Independent Experts on Company taxation

¹¹² Report of the Committee of Independent Experts on Company taxation, p. 13

¹¹³ Report of the Committee of Independent Experts on Company taxation, pp. 14-16; Terra/Wattel (2008), pp. 190-194

¹¹⁴ COM (2001) 582 final, p. 4

¹¹⁵ Recommendation 94/390 and 94/79 respectively

¹¹⁶ Terra/Wattel (2008), p. 195; COM (2001) 260 final, p. 17

¹¹⁷ COM (2001) 260 final, pp. 15-17

¹¹⁸ COM (2001) 260 final, pp. 20-23

¹¹⁹ COM (2001) 582 final, pp. 11-12

¹²⁰ COM (2003) 726 final and COM (2003) 810 final

¹²¹ COM (2003) 726 final, pp. 19-20 and 26

2001 was the best approach in dealing with the tax obstacles for corporations.¹²² As regards the second communication, the Commission held that a non-neutral treatment of inbound or outbound dividend payments were likely to distort the allocation of capital within the Internal Market and that will result in economic inefficiency.¹²³ Therefore, the Member States were asked to assess their legislation in the light of the relevant provisions in the EC Treaty and the Commission were to provide for methods it thought was appropriate; however, the Commission stressed that it would bring infringement proceedings against the Member States were necessary.¹²⁴

In 2006 the Commission issued a communication on the coordination of the direct systems of the Member States. Some key areas were presented, i.e. the removing of discrimination and double taxation, preventing non-taxation and abuse and reducing the compliance costs that follow from being subject to more than one tax system.¹²⁵

The Commission has held its word and during the last few years, it has brought a vast number of infringement proceedings against the Member States. It has for example brought Germany before the ECJ for its provisions concerning outbound dividend payments to companies and Latvia and Lithuania for their provisions that prescribes that outbound dividend payments are taxed more heavily than domestic dividend payments.¹²⁶

To conclude, there is legal integration of the Members States' legislation within the EU, both in a positive and a negative sense. The positive integration is shaped by the adoption of legally binding acts and although these are few in the area of direct taxation, they nonetheless exist and are of great importance. On the other hand, the fact that there are so few legally binding acts in this area increases the importance of the negative integration, which is shaped by the ECJ in its case law and by the Commission. Both ways of integration will be dealt with in the following.

5.1.3 The judicial role of the ECJ

It is also worth considering the judicial role of the ECJ. The Court is not a law-making court; the task of the Court is rather to consider the national law applicable in the cases brought before it and to assess its compatibility with the EC Treaty.¹²⁷ The Court is bound to the provisions of the EC Treaty in the sense that they cannot create any new body of law, it can only clarify the content of e.g. the fundamental freedoms. According to article 220 EC, the task of the ECJ is to "ensure that in the interpretation and application of this Treaty the law is observed." In order for the Court to be able to fulfil its task, it has been given a number of measures to exercise by the subsequent

¹²² Ibid.

¹²³ COM (2003) 810 final, p. 18

¹²⁴ COM (2003) 810 final, pp. 20-21

¹²⁵ COM (2006) 823 final, p. 4

¹²⁶ IP/09/435 and IP/08/334; see also, inter alia, IP/08/1021 concerning Denmark, IP/06/934 concerning Italy and Luxemburg, IP/08/1022 concerning the Czech Republic and Italy, IP/07/21 concerning Italy, IP/07/616 concerning 9 Member States, IP/08/143 concerning Germany, Estonia and the Czech Republic

¹²⁷ Information Note on references from national courts for a preliminary ruling - (2005/C 143/01), 5th indent

EC Treaty provisions. These includes, inter alia, the possibility to, after the application of the Commission or a Member State, to review the legality of certain Community acts (article 230 EC) or to declare that a Member State has failed to comply with its obligations under EC law (article 228 EC).¹²⁸ The most relevant power in respect of the subject of this thesis is the power for the Court to give preliminary rulings on the interpretation of Community law on questions referred to it by the national courts (article 234(1) EC). The Court, when assessing the national legislation, is bound to the question referred to it by the national court.¹²⁹ The Court interprets the EC Treaty in order to see if the national legislation is permitted or precluded.¹³⁰ It does not have the power to declare national provisions to be void and they cannot create any new body of law, they have only the power to interpret sources of law that already exists. The ECJ interprets the EC Treaty as it ought to have been understood from its coming into force.¹³¹ The Court can thus be said to decide the issues in front of it on a case-by-case basis.

The acte clair-doctrine, which allows the national court not to refer a question to the ECJ if the question is sufficiently clear, does not contradict this holding.¹³² As the ECJ interprets the EC Treaty in respect of different kinds of provisions in the legislation of the Member States, the content of the EC Treaty becomes “clear” in certain areas and it is thus not necessary to deal with the issue once more. It must however be stressed once more that the Court, by giving an answer to a question posed by a national court, hasn’t created any new law, it has rather interpreted the provisions in the EC Treaty as they were meant to be understood from their entry into force.

5.2 The Parent-Subsidiary directive

5.2.1 Introduction

The first proposal made for this directive was made in 1969 but it was only adopted some 20 years later, in 1990, and it entered into force in 1992.¹³³ The adopted version varies from the earliest proposals made in several respects, e.g. the adopted version provided for some transitional exceptions and it does not make a choice between CIN or CEN, whereas the first proposal, which was based on CIN, required the Member State of the parent company to exempt incoming dividends from subsidiaries.¹³⁴ It may also be noticed at this point that the directive was amended quite substantially in 2003. The amendments concerned, inter alia, the widening of the scope of the directive by including more legal forms and a lowering of the participa-

¹²⁸ Arnall (2006), p. 33

¹²⁹ Case C-283/83 Srl CILFIT; Case C-144/04 Mangold; Craig/De Búrca (2008), pp. 475-476; Information Note on references from national courts for a preliminary ruling - (2005/C 143/01), 12th indent

¹³⁰ Article 234 EC

¹³¹ Arnall et al. (2006), p. 528

¹³² Case C-283/83 Srl CILFIT; Craig/De Búrca (2008), pp. 474-477 and 478-479

¹³³ Terra/Wattel (2008), p. 475; Brokelind (2003), p. 159

¹³⁴ Terra/Wattel (2008), p. 476

tion threshold and, for states applying the credit system, the mandatory application of a multi-tier credit for underlying tax.¹³⁵

According to the preamble of the directive, it seeks to ensure the proper functioning of the common market by making the grouping of companies subject to rules that are neutral from a competition point of view and thus remove disadvantages and restrictions that stems from the application of tax provisions of the different Member States. The preamble further states that the directive is addressing the issue from two perspectives, both from an inbound and an outbound perspective. For inbound dividend payments the preamble states that the state of the parent company receiving dividends from a subsidiary should provide for an exemption or a credit of the tax already paid by the subsidiary. For outbound dividend payments the preamble states that the state of the distributing subsidiary should refrain from making such a distribution subject to a withholding tax.

5.2.2 Scope

The scope of the directive is laid down in article 1. The article states that the directive is applicable in four different situations. First, the directive shall be applicable to distributions of profit received by a resident company from a subsidiary in another Member State and second, to distributions of profit by a resident company to a parent company resident in another Member State.¹³⁶ Further, the directive shall be applicable to distribution of profit received by a permanent establishment of a company resident in another Member State and paid by a subsidiary resident in another Member State than where the permanent establishment is resident and second, to distributions of profit by a resident subsidiary to a non-resident permanent establishment of a resident parent company of the subsidiary.¹³⁷ However, to be within the scope of the directive, the companies must also be “a company of a Member State” (article 2) and “a parent and subsidiary” (article 3).

To be qualified as “a company of a Member State”, there are three conditions that must be satisfied. First, the company must be incorporated in one of the legal forms listed in the annex to the directive.¹³⁸ Second, the company must be resident for tax purposes in a Member State due to the legislation of that state and it must not have its residence in a non-Member State according to a DTC.¹³⁹ This provision disqualifies dual resident companies but companies having both of their fiscal residences in a Member State do however qualify.¹⁴⁰ To refer to the concept of tax residence can be problematic, since different Member States may define that concept differently.¹⁴¹ The third condition that must be fulfilled is that the company must be subject to one of the corporation taxes listed in article 2(1)(c). Excluded from the scope are companies that are exempted from corporation tax or

¹³⁵ Terra/Wattel (2008), p. 476; Maisto (2004), pp. 171-174 and 175-177

¹³⁶ Article 1, 1st and 2nd indent; Dahlberg (2007), p. 281

¹³⁷ Article 1, 3rd and 4th indent, Dahlberg (2007), pp. 281-282

¹³⁸ Article 2(1)(a)

¹³⁹ Article 2(1)(b)

¹⁴⁰ Terra/Wattel (2008), p. 479

¹⁴¹ Brokelind (2000), p. 336

companies that, although it has the status of a qualifying company, may choose between being subject to tax or subject to fiscal transparency.¹⁴² Some Member States have seen this as an opportunity to prescribe that the company has to be subject to “normal” tax, which must held to be disproportionate to the aim of the directive and this option is not expressed in the directive.¹⁴³ It should be noticed that article 2 does not prescribe that these 3 conditions must be fulfilled within the same Member State.¹⁴⁴ Attention must also be given to the definition of the concept of permanent establishments in article 2(2).

To achieve the status of a parent company, article 3(1)(a) prescribes that a company must fulfil the conditions set out in article 2 and hold at least 20 % of the capital in a company resident in another Member State or, if the companies are resident in the same state, when the shares in the other are held through a permanent establishment resident in another Member State. The minimum holding requirement has gradually been reduced and as of 1 January 2009, that requirement is down to 10 % (article 3(1)(a)). According to article 3(1)(b), a company achieves the status of a subsidiary if it’s owned in accordance with article 3(1)(a). The Member States may apply the benefits of the directive to smaller shareholdings than prescribed and they may replace the minimum shareholding requirement with a matching voting rights requirement.¹⁴⁵

The Court has held that the requirement of a minimum holding in the capital of a company was not to be considered to include the holding in the usufruct of shares.¹⁴⁶ Although the Member States had the right to choose which method to apply to relieve double taxation, the Court held that the state had to relieve double taxation for inbound dividend payments if it had chosen to do so for residents receiving dividends from shares, either with the full title or holdings of usufruct in shares, if the situations between residents receiving domestic dividend payments and inbound dividend payments respectively were comparable.¹⁴⁷

It must be noticed that the Member States may deny companies the status of parent and subsidiary if the shareholding is not held for an uninterrupted period of at least two years.¹⁴⁸ The Member States may also set a shorter period than two years and also to set different periods for the application of articles 4 and 5 or only with regard to one of the articles.¹⁴⁹ One question that has risen is when the minimum holding requirement should be assessed, in retro- or in prospect? The ECJ has held that the Member States may only defer the benefits of the directive temporarily, meaning that it may withhold tax during the first two years but it has to refund the tax levied when that period of time has elapsed.¹⁵⁰

¹⁴² Terra/Wattel (2008), p. 480

¹⁴³ Brokelind (2000), pp. 336-337

¹⁴⁴ Ibid.

¹⁴⁵ Terra/Wattel (2008), p. 484

¹⁴⁶ Judgement by the ECJ in *Les Vergers*, para. 44; for an explanation on the legal character of usufructs in shares, see the Opinion by AG Sharpston in *Les Vergers*, para. 14

¹⁴⁷ Judgement by the ECJ in *Les Vergers*, para. 46-47 and 49

¹⁴⁸ Article 3(2), 2nd indent

¹⁴⁹ Terra/Wattel (2008), p. 484

¹⁵⁰ Brokelind (2000), p. 339

Another issue of interest is the scope of the concept “distributions of profits”.¹⁵¹ As seen here, that concept was preferred ahead of the concept of distribution of a dividend. That might have been done in order not to limit the scope or hamper the fulfilling of the aim of the directive, as the dividend concept is normally seen as somewhat more narrow than the concept of profit distributions.¹⁵² A profit distribution is normally seen as a transaction that decreases the assets of the company and increases the assets of the shareholder.¹⁵³ However, the directive does not provide a definition of the concept and it does not refer to the legislation of either state involved.¹⁵⁴ The concept of profit distributions should thus be seen as a Community law expression and given an autonomous meaning.¹⁵⁵ In order to fulfil the aim of the directive, the concept should be given a broad scope and thus, the concept may include different kinds of actual or fictive dividend equivalent payments if they are made within a “qualifying” context.¹⁵⁶

5.2.3 Outbound dividend payments

Article 5 contains the main rule concerning outbound distributions of profit. It states that a distribution of profits from a subsidiary to a parent company resident in another Member shall be exempt from withholding tax. The wording of the article implies that the exemption is mandatory, thus not permitting the Member States to levy a withholding tax provisionally at the time of the distribution and then refund it; the Member States may however require certain formalities to be fulfilled.¹⁵⁷ A provisional levying of tax is only permitted under article 3(2).

A special issue under this article is the determination of the term withholding tax under the directive. From the cases the Court has decided it may be inferred that the term withholding tax has a very broad scope and has its own meaning under the directive.¹⁵⁸ It seems that its meaning within EC law is broader than the meaning that is given to it in international tax law.¹⁵⁹ Under the directive, “a withholding tax is any tax for which the taxable event is the distribution by a company to its shareholder(s) of any benefit to be regarded as income from shares, and which is calculated on the basis of that distribution”.¹⁶⁰ The name of the tax is immaterial, decisive is rather the characteristics of the tax determined objectively.¹⁶¹

According to article 6, no withholding tax may be levied upon the receipt of the dividend by the parent company in situations when e.g. banks

¹⁵¹ Article 1

¹⁵² Helminen (2000), pp. 162 and 171

¹⁵³ Helminen (2000), p. 162

¹⁵⁴ Helminen (2000), p. 162; Brokelind (2000), p. 340

¹⁵⁵ Terra/Wattel (2008), p. 499; Helminen (2000), p. 162

¹⁵⁶ Terra/Wattel (2008), p. 498-500; Helminen (2000), p. 171; for further reading on the dividend concept, see Helminen (1999), “The dividend concept in International tax law”

¹⁵⁷ Terra/Wattel (2008), p. 501

¹⁵⁸ Terra/Wattel (2008), p. 506; Ståhl/Persson Österman (2006), p. 249; Brokelind (2003), p. 163

¹⁵⁹ Brokelind (2003), p. 163; Ståhl/Persson Österman (2006), p. 249

¹⁶⁰ Terra/Wattel (2008), p. 506

¹⁶¹ Ståhl/Persson Österman (2006), p. 248

handle the transfer of the dividend payment.¹⁶² Further, according to article 7, the directive does not deal with imputation systems.¹⁶³

Last, one must notice that article 5 has been held to have direct effect by the ECJ.¹⁶⁴

5.2.4 Inbound dividend payments

Distributions of profit from a subsidiary, which has already been taxed, received by a (branch of a) parent company in another Member State must not be subject to economic double taxation and thus the Member State of the (branch of the) parent company must either exempt the distribution from tax (the exemption method) or tax the distributed income but allow the receiving company to credit tax already paid on the distributed profits by the subsidiary on its corporation tax due (indirect credit).¹⁶⁵ By giving the Member States the power to decide which method to apply, article 4(1) accepts both of the main theories of how to create efficient taxation systems and prevent international economic double taxation presented above, CIN and CEN.¹⁶⁶ This option was given to the Member States because there was a disagreement in the economic doctrine as to which method was the most efficient and, within the legal doctrine, as to which of the methods that best ascertained the attainment of the aim of the directive.¹⁶⁷ The Member States may apply these methods side by side, as long as they comply with the EC Treaty.¹⁶⁸ The ECJ held recently that article 4(1) has direct effect.¹⁶⁹

Member States that applies the credit method, provides predominantly for a so-called ordinary credit, which means that a credit only will be granted for foreign tax paid on the distributed profits by the distributing subsidiary insofar as it doesn't exceed the corporation tax due on the parent company.¹⁷⁰ The Member States may however, when the foreign tax paid is lower than the tax due on the parent company in its residence state, the latter state may levy an additional tax up to the tax rate of that state.¹⁷¹ After the amendments made in 2003, a credit must also be granted for corporation tax paid by, not only subsidiaries, but also sub-subsidiaries and sub-sub-subsidiaries (multi-tier credit).¹⁷²

It must also be noticed that a paragraph regarding fiscal transparency was inserted into article 4 by the amendments made in 2003. The paragraph deals with the situation when a parent company State has decided to regard the subsidiary in another Member State as fiscally transparent, resulting in

¹⁶² Terra/Wattel (2008), p. 506

¹⁶³ Terra/Wattel (2008), p. 507

¹⁶⁴ Joined cases C-283/94, C-291/94 and C-292/94 *Denkavit*; Terra/Wattel (2008), p. 501; Ståhl/Persson Österman (2006), pp. 247-248; Brokelind (2000), p. 354

¹⁶⁵ Article 4(1)

¹⁶⁶ Terra/Wattel (2008), p. 489

¹⁶⁷ Brokelind (2000), p. 352

¹⁶⁸ Terra/Wattel (2008), p. 488; chapter 5.3.3.6

¹⁶⁹ Case C-138/07 (*Cobelfret*)

¹⁷⁰ Terra/Wattel (2008), p. 490

¹⁷¹ *Ibid.*

¹⁷² Terra/Wattel (2008), p. 490; Ståhl/Persson Österman (2006), pp. 243-244; for a more in-depth assessment, see Maisto (2004), pp. 173-174

the taxation of the part of the profits in the subsidiary when they arise that corresponds with the relative share in that company held by the parent company.¹⁷³ In order to avoid double taxation, Member States applying this option has to refrain from taxing the profits when they are distributed by the subsidiary to the parent company; the parent State must further exempt the amount of the profit included in the parent company's taxable base or credit corporation tax already paid by the subsidiary.¹⁷⁴ The character of fiscal transparency may only be applied to a company due to the application of the domestic company law, thus excluding transparency that derives from the application of the states CFC-legislation.¹⁷⁵

According to article 4(2), the Member States may deny the parent company to deduct any expenses related to the holding in the subsidiary and decreases in the value of the holding due to the distribution of profits. Problems may however arise when the Member State demands that costs incurred must be directly or indirectly related to domestically taxable income in order for it to be deductible.¹⁷⁶

5.2.5 Comments

This chapter has provided a presentation of the Parent-Subsidiary directive and the preferential treatment prescribed by it. It has been shown that the scope of the directive has been gradually increased since it was adopted and now the threshold is 10 % of the capital in the subsidiary. The fact that the term "distribution of profit" has been preferred ahead of the term "dividend", with the first one widely considered to be broader than the latter, has ensured that the directive encompasses as many distributions of profit as possible.

We have also seen that the Member States are to provide relief for inbound dividend payments by either exempting it from tax or to grant the recipient of the distribution a tax credit corresponding to tax already paid in respect of that distribution. Member States applying the credit method is now forced to grant a so-called multi-tier credit. The Community legislator has however, by providing the Member States with the option to choose which method to apply when they seek to avoid economic double taxation, failed to choose between the CIN and CEN theories. As concerns outbound dividend payments, the Member States are obliged to refrain from subjecting this type of distributions of profit to a withholding tax. Both the article concerning inbound distributions of profit and the one concerning outbound distributions has been held to have direct effect by the ECJ.

This chapter has also shown that there remains issues to be dealt with when future amendments of the directive is considered, mainly regarding the wording of the directive and the fact that the directive refers to the concept of tax residence as determined by the domestic legislation of the different Member States.

¹⁷³ Terra/Wattel (2008), p. 500; Ståhl/Persson Österman (2006), p. 244

¹⁷⁴ Terra/Wattel (2008), p. 500; Maisto (2004), p. 175

¹⁷⁵ Terra/Wattel (2008), pp. 500-501; Maisto (2004), p. 175; Ståhl/Persson Österman (2006), p. 244

¹⁷⁶ Terra/Wattel (2008), p. 492

5.3 Dividend payments assessed in the light of the EC Treaty

5.3.1 Introduction

The treatment of inbound and outbound dividend payments provided for by the Parent-Subsidiary directive was assessed in the previous chapter. This chapter deals with outbound and inbound dividend payments that don't fall within the scope of the Parent-Subsidiary directive, which results in that the issues arising in these cases will be assessed in the light of the fundamental freedoms in the EC Treaty. The presentation of the case law will be split into two different chapters based on the nature of the dividend payment, if it concerns an outbound or an inbound dividend payment. Within these two chapters, the cases will be presented in a chronological order, with the oldest case first. The facts of the case will be presented together with the opinion by the AG and then the judgement of the ECJ will be presented in a separate chapter.

Before I move on to present the different cases, a distinction has to be made between restrictions and discrimination. The concept of discrimination requires that the measure, in effect or directly, distinguish between foreign and domestic economic operators or goods, whereas no such requirement needs to be fulfilled in order for a restriction to be found.¹⁷⁷ In respect of, for example, the free movement of capital, a restriction is found to exist if the national measure hinders the free movement of capital.¹⁷⁸ With regard to tax cases, a discrimination on the basis of nationality or origin is most likely to arise in cases where non-residents doesn't receive the same treatment as residents in the host-state (state of residence) or where inbound income is not taxed in the same way as domestic income.¹⁷⁹ A restriction is likely to be caused by exit taxation and similar measures in the origin-state (state of source), hindering cross-border movement as compared to domestic movements.¹⁸⁰

5.3.2 Outbound dividend payments

5.3.2.1 Avoir fiscal

5.3.2.1.1 Judgement by the ECJ

In this case, the national legislation provided for a corporation income tax at 50 %. Companies were taxed irrespective of where their registered office was situated; however, account was only taken of profits made by corporations operating in France or by companies that was liable to tax due to the application of a DTC.¹⁸¹

¹⁷⁷ Terra/Wattel (2008), p. 63

¹⁷⁸ Ibid.

¹⁷⁹ Terra/Wattel (2008), p. 64

¹⁸⁰ Terra/Wattel (2008), pp. 63-64

¹⁸¹ Avoir fiscal, para. 2

In order to reduce the double taxation created due to the fact that distributed profits was taxed first in the hands of the corporation and second in the hands of the shareholder, France applied a relief system. The recipient of the dividend was able to get a tax credit, “avoir fiscal”, on half of the tax paid by the company.¹⁸² The recipient of the dividends could use the tax credit in order to set off some of the corporate income tax already paid against the individual income tax.¹⁸³ This credit was however only granted to individuals that had their habitual residence in France or, for companies, which had their registered office in France and also to persons who were residing in a state that had concluded a DTC with France.¹⁸⁴ It should also be noticed that the tax credit could be granted to French insurance companies and foreign insurance companies with subsidiaries in France for their holding of shares in French companies.¹⁸⁵ It could not however be granted to secondary establishments in the form of branches or agencies by insurance companies that had their registered office in another Member State.¹⁸⁶

The Commission lodged a complaint in front of the ECJ, in which it sought to get declared that by not granting the shareholder credit to secondary establishments in France set up by insurance companies in other Member States, France was violating the EEC Treaty, in particular article 52 thereof.¹⁸⁷

The Court started by stating that article 52 of the EEC Treaty gave corporations the right to set up secondary establishments in another Member State under the conditions applicable to the nationals of the state. The article ensured that foreign companies that established themselves in another Member State receive the same treatment as the nationals of the state and it prohibited discrimination on the ground of nationality.¹⁸⁸ The Court found that, since foreign insurance companies with secondary establishment in the form of branches and agencies were not granted the benefit of the tax credit, they were not treated in the same way as insurance companies with registered office in France.¹⁸⁹

In order to try to justify the abovementioned distinction, the French government argued that the distinction was based on the internationally accepted distinction between residents and non-residents.¹⁹⁰ In response to this argument, the Court stated that article 52 EC granted corporations in the Member States the right to set up secondary establishments within the other Member States and it stressed the fact that the registered office served as a connecting factor in order to determine the residence of a company.¹⁹¹ The Court thought that to allow a rule such as the French one would render article 52 useless.¹⁹² The Court also pointed to the fact that the French legisla-

¹⁸² Avoir fiscal, para. 3

¹⁸³ Ibid.

¹⁸⁴ Avoir fiscal, para. 4

¹⁸⁵ Avoir fiscal, para. 6

¹⁸⁶ Ibid.

¹⁸⁷ Avoir fiscal, para. 1

¹⁸⁸ Avoir fiscal, para. 14

¹⁸⁹ Avoir fiscal, para. 16

¹⁹⁰ Avoir fiscal, para. 17

¹⁹¹ Avoir fiscal, para. 18

¹⁹² Ibid.

tion did not distinguish between branches and agencies of companies resident in France and of companies with their registered office in another Member State, when determining the income liable to corporation tax in France.¹⁹³ By doing so, France had admitted that there was no objective difference between the two that could justify the exclusion of the possibility to obtain the tax credit and, in such a situation, to treat the two sets of companies differently.¹⁹⁴ The Court held that the French legislation gave rise to discrimination and it rejected the arguments put forward that the concerned difference in treatment might be justified by advantages that cancel out the disadvantage created by the fact that the tax credit is not granted.¹⁹⁵

The Court rejected arguments put forward relating to the interaction between different systems of taxation in the Member States and the risk of tax avoidance.¹⁹⁶ It also rejected that the difference in treatment was due to the application of a DTC since, according to the Court, such agreements does not deal with the relevant issues in the case; the rights in article 52 EC was unconditional and they could not be made subject to any agreement concluded with another Member State.¹⁹⁷

5.3.2.1.2 Comments

This case concerned the freedom of establishment and the Court held that the French legislation created a restriction on this freedom as it refused French branches of foreign insurance companies a tax credit that was granted to legal persons considered to have their residence in France, e.g. subsidiaries of foreign insurance companies. Both branches and subsidiaries were taxed due to the application of the residence principle and were therefore in a comparable situation.

The main lesson to learn from this case is that the Court does not allow the Member State to make a distinction between a branch or a subsidiary; the shareholders of the branch should be granted the same tax credit as was granted to the shareholders of the subsidiary.

5.3.2.2 Metallgesellschaft

5.3.2.2.1 Opinion by the AG

This case concerned the UK tax system concerning the taxation of corporate income and profit distributions. Under this system, corporation tax (CT) was charged on profits made by companies resident in the UK as well as profits made by secondary establishments within the UK.¹⁹⁸ The main issue in the case was however the payment of so called advance corporation tax (ACT). ACT was due on certain qualified profit distributions, most typically dividend payments, made by companies resident in the UK.¹⁹⁹ If ACT was paid by a corporation, that corporation was in principle able to use the ACT paid

¹⁹³ Avoir fiscal, para. 19

¹⁹⁴ Avoir fiscal, para. 20

¹⁹⁵ Avoir fiscal, para. 20-21

¹⁹⁶ Avoir fiscal, para. 24-25

¹⁹⁷ Avoir fiscal, para. 26

¹⁹⁸ Opinion by the AG in Metallgesellschaft, para. 2

¹⁹⁹ Opinion by the AG in Metallgesellschaft, para. 3

to offset the CT payable during the same accounting period or it could be transferred to the corporation's subsidiaries and they could set it off against their CT liability.²⁰⁰

Under the UK legislation, a group income election was available for companies who owned at least 51 % of another company and if both of them were residents in the UK.²⁰¹ If this possibility was used, the subsidiary was not obliged to pay ACT on dividends distributed to the parent company, unless it wanted to be liable to ACT.²⁰²

Further, a payment of ACT by a subsidiary on dividends distributed to the parent company, gave the latter one a right to a tax credit, if the parent company was resident in the UK.²⁰³ If the parent company receiving a dividend payment on which ACT had been paid was wholly exempt from CT, then that company was entitled to an reimbursement equal to the ACT paid on the dividends.²⁰⁴ Companies with residence in the UK were not liable to CT on dividends paid, nor were such dividends taken into account for CT purposes.²⁰⁵ Non-residents were not liable to CT, but they were liable to UK income tax for income that had its source in the UK.²⁰⁶ However, if a non-resident parent company received a dividend payment from a UK resident subsidiary on which it was not entitled to a tax credit, it was not subject to UK income tax either; if the company was entitled to a tax credit due to the application of a DTC, it was liable for income tax on dividends received from the UK.²⁰⁷

The plaintiffs in the proceedings claimed that their UK subsidiaries had suffered a cash-flow disadvantage since, because they were non-resident companies, they could not use the option of group income election.²⁰⁸ According to them, this constituted discrimination contrary to articles 6 and 52 of the EC Treaty.²⁰⁹

The AG held that by not extending the option of group relief to non-residents, the UK legislation constituted a restriction contrary to the freedom of establishment.²¹⁰ He came to this conclusion by rejecting the two arguments put forward by the UK government trying to justify the national legislation, to protect the tax revenues and to preserve the fiscal cohesion of the tax system. The first ground was not accepted due to the fact that the ACT was held to be an advance payment of CT and to grant non-resident parent companies the possibility to exercise the group income election would only give them the opportunity to enjoy the same tax flow advantage as subsidiaries with UK-resident parent companies.²¹¹ The AG did not see that the granting of this benefit would facilitate tax avoidance or granting the com-

²⁰⁰ Opinion by the AG in *Metallgesellschaft*, para. 4

²⁰¹ Opinion by the AG in *Metallgesellschaft*, para. 5

²⁰² *Ibid.*

²⁰³ Opinion by the AG in *Metallgesellschaft*, para. 6

²⁰⁴ *Ibid.*

²⁰⁵ Opinion by the AG in *Metallgesellschaft*, para. 7

²⁰⁶ *Ibid.*

²⁰⁷ *Ibid.*

²⁰⁸ Opinion by the AG in *Metallgesellschaft*, para. 10

²⁰⁹ *Ibid.*

²¹⁰ Opinion by the AG in *Metallgesellschaft*, para. 39

²¹¹ Opinion by the AG in *Metallgesellschaft*, para. 22

panies an exemption from ACT.²¹² On the second ground of justification, the AG examined the concept of fiscal cohesion in some detail. He arrived at the conclusion that there needed to be a direct and organic link between the tax and the exemption or relief there from.²¹³ He found no such link in the national legislation at issue and argued further that the view that the rules might be justified by the need to preserve the fiscal cohesion of the tax system was based on the misconception that that ACT should be viewed separately from the CT.²¹⁴ He further argued that the objectively different positions for resident and non-resident parent companies for CT purposes could not justify the imposition of a higher CT burden on the subsidiaries of the latter.²¹⁵ The AG stated last that if the ECJ should think otherwise, then at least it should hold that the legislation was disproportionate.²¹⁶

5.3.2.2.2 Judgement by the ECJ

The ECJ held that the difference in treatment that the UK legislation gave rise to created a cash flow disadvantage for UK subsidiaries with non-UK resident parent companies.²¹⁷ The Court then, like the AG, held that the ACT was an advanced payment of CT and by granting UK subsidiaries with non-UK resident parents the option of group income election, would only give them the same cash flow advantage that UK subsidiaries with UK parents had.²¹⁸ The exclusion of the benefit of exemption for the subsidiary when it made dividend payments to its parent could not be justified by the fact that the non-resident parent company wasn't liable to ACT.²¹⁹ The Court also rejected the arguments for justification put forward based on the loss of revenue for the UK and the risk of tax avoidance.²²⁰

Last, the Court examined the last ground for justification put forward, the need to preserve the cohesion of the tax system. This argument was however rejected by the Court.²²¹ The rejection was based on the fact that there did not seem to be a direct link between the refusal to grant UK subsidiaries of non-resident parent companies the benefit of exemption from ACT and the fact that parent companies with their seat in another Member State that received dividend payments from their UK subsidiaries was not liable to UK CT.²²²

5.3.2.2.3 Comments

This case concerned the UK ACT system, which resembled an imputation system. The Court held that a restriction arose when the UK legislation prescribed that a benefit named group income election wasn't available for for-

²¹² Opinion by the AG in *Metallgesellschaft*, para. 22-23

²¹³ Opinion by the AG in *Metallgesellschaft*, para. 33

²¹⁴ Opinion by the AG in *Metallgesellschaft*, para. 35

²¹⁵ *Ibid.*

²¹⁶ Opinion by the AG in *Metallgesellschaft*, para. 37

²¹⁷ Judgement by the ECJ in *Metallgesellschaft*, para. 43-44

²¹⁸ Judgement by the ECJ in *Metallgesellschaft*, para. 52-54

²¹⁹ Judgement by the ECJ in *Metallgesellschaft*, para. 55

²²⁰ Judgement by the ECJ in *Metallgesellschaft*, para. 57-59

²²¹ Judgement by the ECJ in *Metallgesellschaft*, para. 73

²²² Judgement by the ECJ in *Metallgesellschaft*, para. 69

eign subsidiaries, when it was available for UK subsidiaries. It is possible to derive from this case that the Court thought that UK and foreign subsidiaries was in a comparable situation and the benefit of the group had to be extended to foreign subsidiaries, as that would only allow them to enjoy the same cash-flow advantage as the UK subsidiaries. Discrimination based on the place of residence was thus not allowed.

The reasoning of the Court in this case has been subject to criticism, as it, allegedly, failed to consider the whole chain of events from the distributor to the recipient of the dividend.²²³

5.3.2.3 Fokus Bank (the EFTA Court)

5.3.2.3.1 Judgement by the Court

This case concerned a dividend distribution by a Norwegian joint stock Company to its subsidiaries, of which two were residents in Germany and the UK.²²⁴ Before the decision to distribute the dividends were taken, the shareholder decided to sell the shares to companies who were residents in Norway and then, after the distribution, they exercised a right to buy the shares back.²²⁵ The Norwegian company withheld withholding tax, as it was obliged to since the company receiving the dividends were non-residents; had the recipient been a resident, no such obligation would have risen.²²⁶ In order to relieve economic double taxation, Norway applied an imputation system at the time, meaning that, if the shareholder was residing in Norway, he was granted an imputation credit that corresponded to the corporation tax paid on the dividends received.²²⁷ No such credit was granted to non-residents but this right could be extended due to the application of a DTC.²²⁸ In this case, the credit was however not equal to the amount granted to residents in Norway.²²⁹

The Court held that, even though the States are at liberty to allocate their taxing powers among each other, they had to do this in accordance with EEA law.²³⁰ After stating that one of the main objectives with the EEA agreement was to create a homogenous market and that the rules in that agreement concerning the free movement of capital was virtually the same, the Court held that this rule was applicable to the situation in the proceedings, referring in this part to the judgement by the ECJ in *Verkooijen*.²³¹ The Court concluded that the Norwegian legislation created a restriction against the free movement of capital since it could lead to a negative treatment of the profit of non-resident shareholders in Norwegian companies and this could deter them from investing in companies with residence in Norway.²³²

²²³ Graetz/Warren (2007), p. 1605

²²⁴ Judgement by the EFTA Court in Fokus bank, para. 2

²²⁵ Ibid.

²²⁶ Judgement by the EFTA Court in Fokus bank, para. 3

²²⁷ Judgement by the EFTA Court in Fokus bank, para. 9

²²⁸ Judgement by the EFTA Court in Fokus bank, para. 10-11

²²⁹ Judgement by the EFTA Court in Fokus bank, para. 11

²³⁰ Judgement by the EFTA Court in Fokus bank, para. 21

²³¹ Judgement by the EFTA Court in Fokus bank, para. 22-24

²³² Judgement by the EFTA Court in Fokus bank, para. 26

A number of reasons for the justification of the legislation were put forward but the Court rejected all of them. First of all, the Court rejected that the situation between a resident and a non-resident was not comparable due to the fact that the situations could not be held to be incomparable only by the fact that one was taxed due to a connection by residence and the other one taxed due to a connection by source.²³³ The Court also took guidance from the case law of the ECJ concerning inbound dividends, although it acknowledged the fact that this case concerned outbound dividends.²³⁴ The Court held that if the purpose with the legislation was to be achieved, then the same credit had to be given to all shareholders, irrespective of their place of residence, because economic double taxation will create the same effect no matter where the shareholder had his residence.²³⁵ It thus thought that the situations were comparable.²³⁶

The Court also rejected an argument based on the cohesion of the international tax system and the fact that this disadvantage was offset by another advantage.²³⁷ The latter argument was rejected due to the fact that a restriction against one of the fundamental freedoms could never be justified by a tax advantage and a State could never shift the obligation to comply with the EEA by relying on another State to make up for the disadvantage created.²³⁸

5.3.2.3.2 Comments

The EFTA Court held the Norwegian legislation applicable in this case to create a restriction on the free movement of capital, as it didn't grant non-residents receiving a dividend payment with its source in Norway an imputation credit for corporation tax paid in respect of the dividend in Norway, whereas such a credit was granted to residents. The EFTA Court was guided by the case law of the ECJ concerning inbound dividend payments, although this case concerned an outbound dividend payment.

An interesting aspect is that the EFTA Court and the ECJ seems to have adopted different views on the question of whether a difference in treatment in the state of source could be neutralized by an advantage provided for by a DTC or the national legislation of the state of residence of the recipient of the dividend.²³⁹ It has been argued that the holding by the EFTA Court is in compliance with the holding made by the ECJ in ACT Test Claimants.²⁴⁰

²³³ Judgement by the EFTA Court in Fokus bank, para. 29

²³⁴ Judgement by the EFTA Court in Fokus bank, para. 30

²³⁵ Ibid.

²³⁶ Ibid.

²³⁷ Judgement by the EFTA Court in Fokus bank, para. 31-37

²³⁸ Judgement by the EFTA Court in Fokus bank, para. 37

²³⁹ Bullen (2007), p. 273; Graetz/Warren (2007), p. 1600; Terra/Wattel (2008), p. 188, footnote 104

²⁴⁰ Terra/Wattel (2008), p. 188

5.3.2.4 Bouanich

5.3.2.4.1 Opinion by the AG

This case concerned the Swedish legislation applicable to the proceeds from a sale of shares to a company when this sale constitutes a buy back of shares. Under the Swedish law applicable at the time, a repurchase by a Swedish share company from a Swedish resident, was taxed as a capital gain, which meant that the applicable rate was 30 %.²⁴¹ If the share was repurchased from a non-resident, the payment was treated as a dividend, for which the same tax rate applied but the acquisition costs could not be deducted.²⁴² Of relevance to this case is that there was a DTC between the states that was based on the OECD model convention.²⁴³

In the case, a French resident, Ms Bouanich, sold back shares to the company for around SEK 8.6 million.²⁴⁴ According to the Swedish law and the applicable DTC, 15 % of this was withheld at source. Ms Bouanich lodged a complaint and sought a refund of the whole amount or alternatively, refund of the tax charged on the nominal value of the shares.²⁴⁵ The tax authorities accepted the alternative claim, but Ms Bouanich brought proceedings against this decision.²⁴⁶

AG Kokott held first, after concluding that the repurchase of shares fell within the notion of capital movements, that the Swedish legislation contained a difference in treatment based on the place of residence and, second, that the legislation created a restriction on capital movements.²⁴⁷ The second finding was based on the fact that the main objective with investments is to earn net income and thus the tax treatment of the proceeds of such investments will affect the attractiveness of investing in the state.²⁴⁸ If foreign investors would not be able to, in the event of a repurchase of shares, deduct their acquisition costs, then this might, according to AG Kokott, affect the attractiveness of investing in Sweden; it could also deter Swedish companies from seeking investments from abroad.²⁴⁹ The AG did not find any argument put forward to justify the Swedish legislation to be applicable.²⁵⁰

At the end, the AG considered the implications that the applicable DTC might have. First she held that the Member States remained at liberty to seek to abolish the double taxation that might arise, but this must be done in accordance with EC law.²⁵¹ The AG also saw that the DTC improved the situation of the taxpayer as compared to the national law.²⁵² The agreement prescribed that the nominal value of the shares may be deducted from the

²⁴¹ Opinion by AG Kokott in Bouanich, para. 7

²⁴² Opinion by AG Kokott in Bouanich, para. 8

²⁴³ Opinion by AG Kokott in Bouanich, para. 14

²⁴⁴ Opinion by AG Kokott in Bouanich, para. 17

²⁴⁵ Opinion by AG Kokott in Bouanich, para. 18

²⁴⁶ Opinion by AG Kokott in Bouanich, para. 20

²⁴⁷ Opinion by AG Kokott in Bouanich, para. 27-28, 32-33

²⁴⁸ Opinion by AG Kokott in Bouanich, para. 33

²⁴⁹ Opinion by AG Kokott in Bouanich, para. 33-34

²⁵⁰ Opinion by AG Kokott in Bouanich, para. 40

²⁵¹ Opinion by AG Kokott in Bouanich, para. 46-47

²⁵² Opinion by AG Kokott in Bouanich, para. 57

taxable amount and an upper limit on the tax rate.²⁵³ She however thought that the acquisition costs often are considerably higher than the nominal value and thus the allowance of the deduction of the nominal value might not lead to complete equality between residents and non-residents.²⁵⁴ She then left it for the national court to decide if equality was at hand in the present case.²⁵⁵

5.3.2.4.2 Judgement by the ECJ

The ECJ, like the AG, found that the repurchase of shares fell within the notion of capital movements and thus applied the freedom of movement for capital.²⁵⁶ It held that the national legislation reserved the possibility of deduction of the acquisition costs to resident shareholders and that might deter investors from investing in Swedish companies and deter Swedish companies from seeking investments from abroad.²⁵⁷ The legislation at issue thus constituted a restriction on the free movement of capital for which the Court found no justification.²⁵⁸

As regards the possible implications of the applicable DTC, the Court found first that the Member States have competence to allocate their taxing powers among each other, as long as they comply with EC law.²⁵⁹ The Court then held that it had to take account of the DTC since it had been presented as a part of the legal background; it stressed that it would not interpret national law or assess its application in the present case.²⁶⁰ The Court concluded that non-residents were able to deduct the nominal value and the remaining amount was taxed at a rate of 15 %, which had to be compared to the treatment of residents, which were taxed at 30 % but were able to deduct the acquisition costs.²⁶¹ This comparison was however to be made by the national court since it was outside the competence of the Court.²⁶²

5.3.2.4.3 Comments

It is possible to derive from this case that non-residents recipients of outbound dividend payments may be subject to a different treatment than residents, but they mustn't be subject to a higher tax in practice than residents.²⁶³ In this case, non-residents weren't able to deduct the acquisition costs of the shares, whereas this was possible for residents. As regards the application of the applicable DTC, the Court stated that it would consider it when it had been presented as a part of the legal context in the case, but it would not interpret it or the domestic law and/or the application of them.

²⁵³ Opinion by AG Kokott in Bouanich, para. 58-59

²⁵⁴ Opinion by AG Kokott in Bouanich, para. 62

²⁵⁵ Opinion by AG Kokott in Bouanich, para. 65

²⁵⁶ Judgement by the ECJ in Bouanich, para. 29

²⁵⁷ Judgement by the ECJ in Bouanich, para. 32 and 34

²⁵⁸ Judgement by the ECJ in Bouanich, para. 41-43

²⁵⁹ Judgement by the ECJ in Bouanich, para. 49-50

²⁶⁰ Judgement by the ECJ in Bouanich, para. 51

²⁶¹ Judgement by the ECJ in Bouanich, para. 52-53

²⁶² Judgement by the ECJ in Bouanich, para. 54-55

²⁶³ Terra/Wattel (2008), p. 827

It has been suggested that the Court abandoned the principle of source state entitlement in this case, as it demanded Sweden to extend the possibility to deduct the acquisition costs in respect of repurchases of shares.²⁶⁴

5.3.2.5 ACT Test Claimants

5.3.2.5.1 Opinion by the AG

The legal context in this case was the same as in *Metallgesellschaft*. It concerned the British tax regime ACT, which formed part of the then applicable imputation system that sought to relieve double taxation that might occur due to the fact that profit of the companies was taxed both in the hands of the corporation and in the hand of the individual shareholder.²⁶⁵

Under the section in which I dealt with *Metallgesellschaft*, I made a description of the ACT regime and I kindly ask the reader to see that section if needed. However, I would like to point to some things at this stage. If a corporate shareholder resident in the UK received a dividend from a subsidiary and if the distributing company was also a resident in the UK, the corporation tax was not chargeable on the dividend; the receiving company was also entitled to a tax credit corresponding to the ACT paid by the subsidiary.²⁶⁶ The tax credit constituted, together with the dividend, so called “franked investment income” and UK-resident companies was only liable to pay ACT on the difference between its franked payments and its franked investment income, which meant that ACT was only paid once if carried up through a group of British companies.²⁶⁷ This was in addition to the advantage of the option to exercise the group income election scheme that was addressed in *Metallgesellschaft*. If the corporate shareholder was a non-resident, it was not liable to corporation tax but was in principle liable to UK tax if the income had its source within the UK; this liability ceased if the recipient was not entitled to a tax credit.²⁶⁸ A non-resident was under UK law not entitled to a tax credit, unless a DTC stipulated otherwise.²⁶⁹ At the material time, the entitlement to tax credit varied from treaty to treaty.²⁷⁰

After holding that he had to assess the national legislation in the light of both the freedom of establishment and the freedom of movement for capital, the AG went on to deal with the concepts of restriction and discrimination and he found that, for direct tax purposes, there was no practical difference.²⁷¹ He thought that the term “restriction” should be viewed in two different ways. The first was restrictions caused by the co-existence of national tax systems.²⁷² These “quasi-restrictions” exists because different tax systems must exist side by side and that will lead to advantages and to disadvantages.²⁷³ AG Geelhoed thought that these “quasi-restrictions should be

²⁶⁴ *Ibid.*

²⁶⁵ Opinion by AG Geelhoed in ACT Test Claimants, para. 2,4-5, 7, 8-9

²⁶⁶ Opinion by AG Geelhoed in ACT Test Claimants, para. 12

²⁶⁷ *Ibid.*

²⁶⁸ Opinion by AG Geelhoed in ACT Test Claimants, para. 13

²⁶⁹ *Ibid.*

²⁷⁰ Opinion by AG Geelhoed in ACT Test Claimants, para. 15-18

²⁷¹ Opinion by AG Geelhoed in ACT Test Claimants, para. 30 and 36

²⁷² Opinion by AG Geelhoed in ACT Test Claimants, para. 37 and para. 41-54

²⁷³ Opinion by AG Geelhoed in ACT Test Claimants, para. 38

held to fall outside the scope of article 42 EC.²⁷⁴ The second qualification of the term “restriction” was to see it, as what AG Geelhoed called, “true” restrictions, restrictions that does not flow from the co-existence of different tax systems; these restrictions should, according to the AG, fall within the scope of article 43 EC.²⁷⁵ The AG made a distinction as to when a restriction could be said to be at hand, based on whether the state was acting in a home state or a source state capacity.²⁷⁶ In essence, the obligations of the home state were to treat foreign-sourced income in consistency with the way the state had divided its tax base, i.e. if the state had chosen to treat such income as taxable income, it should not discriminate between such income and domestic income.²⁷⁷ The AG found support for his view in the case law of the ECJ, The Court had previously held, concerning corporate income tax, that if a state was acting in a home state capacity and had chosen to relieve economic double taxation on its residents’ dividends and had tax jurisdiction on the worldwide income of its residents, that state would have to provide the same relief for incoming foreign-sourced dividends as for domestic dividends.²⁷⁸ When doing so it had to take foreign corporation tax paid into account.²⁷⁹ For states acting in a source state capacity, they was to treat foreign-sourced income no less favourably than domestic income, insofar as the state had chosen to include such income in its tax jurisdiction.²⁸⁰ For example, if tax benefits were granted to companies resident in the state, the same benefits had to be granted to branches in the state of foreign companies, if they were liable to corporation tax in the same way as residents.²⁸¹

When the AG applied the principles set out above, he came to the conclusion that it was not against the EC Treaty to not extend a partial or full tax credit for dividends paid by a UK resident subsidiary to a non-resident parent company if these dividends were not subject to UK income tax.²⁸² However, where the UK had chosen to exercise tax jurisdiction over dividends due to a DTC, the UK had to treat these dividends in a non-discriminatory manner as compared to the same UK income.²⁸³ The AG further held that it could not be held to be contrary to the EC Treaty to entitle residents of one Member State to a tax credit and not the other and he also held that it was not contrary to the treaty to make the entitlement of such a credit subject to a limitation of benefits clause.²⁸⁴

5.3.2.5.2 Judgement by the ECJ

The ECJ stated first that both the freedom of establishment and the freedom of movement for capital could be applied to the situations in the proceedings, since the holdings in the companies might or might not give the share-

²⁷⁴ Opinion by AG Geelhoed in ACT Test Claimants, para. 39

²⁷⁵ Opinion by AG Geelhoed in ACT Test Claimants, para. 40

²⁷⁶ Opinion by AG Geelhoed in ACT Test Claimants, para. 57

²⁷⁷ Opinion by AG Geelhoed in ACT Test Claimants, para. 58

²⁷⁸ Ibid.

²⁷⁹ Ibid.

²⁸⁰ Opinion by AG Geelhoed in ACT Test Claimants, para. 66-67

²⁸¹ Ibid.

²⁸² Opinion by AG Geelhoed in ACT Test Claimants, para. 91

²⁸³ Ibid.

²⁸⁴ Opinion by AG Geelhoed in ACT Test Claimants, para. 96 and 102

holders definite influence over the decisions in the company and thus determine the activities of the company.²⁸⁵ From there, the Court moved on to state that the Member States remained at liberty to determine the criteria for allocating their taxing powers among each other.²⁸⁶ This liberty was however limited by the Parent-Subsidiary directive, which applied to holdings above 25 % in the capital of a company in another Member State; but even when this threshold wasn't attained, the Member States had to comply with Community law when they were seeking to eliminate double taxation.²⁸⁷ Where a Member State had chosen to relieve the effect of economic double taxation for dividends paid to resident companies by another resident company, it had to do so for dividends paid by non-resident companies to resident companies, because the resident companies receiving the dividends were in a comparable situation since the dividends distributed might be subject to tax both at corporate and at shareholder level.²⁸⁸ However, the Court held that the situations were not comparable when the two concerned companies were not resident in the same state and when it concerned the relieving of economic double taxation.²⁸⁹ To ask the state from which the profits were derived to relieve the double taxation that might arise was to ask it to abandon the right to tax at source and it was also the home state of the recipient that was best placed to assess the receiver's ability to pay.²⁹⁰ Therefore the Court held that there was no difference in treatment between a payment from a UK resident company to either a resident company or a foreign company.²⁹¹

There was however, according to the Court, a difference in treatment between resident and non-resident companies when they were receiving dividends and the first one, but not the latter, was granted a tax credit in order to relieve economic double taxation.²⁹² The position of a Member State in which both the distributing company and the ultimate shareholder were residents of that state and the position of a Member State in which a resident company made a distribution to a non-resident shareholder that in turn paid it to the ultimate shareholders were not comparable according to the Court.²⁹³ But if a Member State had chosen to extend its taxing jurisdiction to non-residents, the non-residents became comparable to residents, since they were both taxed when receiving dividends.²⁹⁴ This was done when the UK had chosen to entitle residents of other states to a full or partial tax credit in a DTC with that other state; when this was done, the state imposing liability to tax to non-residents had to ensure that these would not be discriminated against as compared to residents.²⁹⁵

²⁸⁵ Judgement by the ECJ in ACT Test Claimants, para. 38-40

²⁸⁶ Judgement by the ECJ in ACT Test Claimants, para. 52

²⁸⁷ Judgement by the ECJ in ACT Test Claimants, para. 53-55

²⁸⁸ Judgement by the ECJ in ACT Test Claimants, para. 55-56

²⁸⁹ Judgement by the ECJ in ACT Test Claimants, para. 57-58

²⁹⁰ Judgement by the ECJ in ACT Test Claimants, para. 59-60

²⁹¹ Judgement by the ECJ in ACT Test Claimants, para. 61

²⁹² Judgement by the ECJ in ACT Test Claimants, para. 63

²⁹³ Judgement by the ECJ in ACT Test Claimants, para. 65

²⁹⁴ Judgement by the ECJ in ACT Test Claimants, para. 68

²⁹⁵ Judgement by the ECJ in ACT Test Claimants, para. 53-55

The Court held that, due to the fact, among others, each DTC was concluded in its own specific context and that there was a link between the granting of a tax credit and the applicable rate in the agreement, a company in a state that had concluded a convention with the UK that entitled a company to a tax credit was not in a comparable situation to a company in a state that had concluded a convention with the UK that didn't include such an entitlement.²⁹⁶

5.3.2.5.3 Comments

From this case it is possible to derive that the state of source is not obliged to eliminate double taxation for non-residents, even if it does so for residents, if it hasn't made non-residents liable to tax in the state in a way that makes them comparable to residents.²⁹⁷ Some writers have suggested that the distinction made by the Court between this case and *Denkavit Internationaal* was wrong, as it fails to recognize the similarity in function between a withholding tax and an imputation system, whereas other writers have defended the distinction made by the Court.²⁹⁸ It has also been suggested that the Court, by stating that the state of source could not be asked to relinquish its right to at source, made the choice of applying the principle of source state entitlement and that this was confirmed by the Court in the *FII Test Claimants*.²⁹⁹

Contrary to the EFTA Court in *Fokus Bank*, the ECJ held that a difference in treatment in the state of source could be neutralized by an advantage provided for by a DTC or the national legislation of the state of residence of the recipient of the dividend.³⁰⁰

5.3.2.6 *Denkavit International BV*

5.3.2.6.1 Opinion by the AG

The French law applicable in this case prescribed that a withholding tax was to be levied on the income from shares at a rate of 25 %.³⁰¹ The withholding tax was not levied when dividends were distributed from a French subsidiary to a French parent company. Dividends received by French companies or bodies subject to French corporation tax was, due to the application of a special regime, almost exempted from corporation tax in the hand of the parent company and was deducted from the taxable profit of the parent, except for 5 %.³⁰² The applicable DTC allocated the right to tax to the state of the receiver of the dividend, but the source state retained a right to tax the dividends, which was limited to taxation at a rate of 5 %.³⁰³

²⁹⁶ Judgement by the ECJ in *ACT Test Claimants*, para. 86-91

²⁹⁷ *Terra/Wattel* (2008), p. 828

²⁹⁸ *Vanistendael* (2007), p. 212; *Graetz/Warren* (2007), p. 1615; see chapter 3.1, p. 16

²⁹⁹ *Terra/Wattel* (2008), pp. 811 and 828; *Graetz/Warren* (2007), pp. 1606-1607; *Lang* (2008), p. 73

³⁰⁰ *Bullen* (2007), p. 273; *Graetz/Warren* (2007), p. 1600; *Terra/Wattel* (2008), p. 188, footnote 104

³⁰¹ Opinion by AG Geelhoed in *Denkavit*, para. 3

³⁰² Opinion by AG Geelhoed in *Denkavit*, para. 4

³⁰³ Opinion by AG Geelhoed in *Denkavit*, para. 5

The case concerned dividends distributed from a French subsidiary to a Dutch parent company, on which the subsidiary was forced to withhold the 5 % withholding tax as seen above.³⁰⁴ Under Dutch law, inbound dividend payments to a Dutch parent company from the French subsidiary was exempt from Dutch tax in the hands of the parent company.³⁰⁵ The French withholding tax was challenged and it was claimed that it was contrary EC law and the non-discrimination clause in the DTC.³⁰⁶

The AG started by concluding that the taxing jurisdiction that France subjected outbound dividends to was restricted to what is normally called source-State jurisdiction, i.e. it had jurisdiction to tax income that had risen within its territory.³⁰⁷ As seen in ACT Test claimants, AG Geelhoed presented some obligations for the source state under article 43 EC. Applying those principles to this case, the AG found that the French legislation in this case gave rise to discrimination, since it relieved economic double taxation for dividends distributed domestically, but imposed economic double taxation for dividends leaving the territory of France.³⁰⁸ As he was not convinced by the arguments advanced by the French government, he held that the legislation constituted discrimination.³⁰⁹

The AG then considered the effects of the applicable DTC. To start with, the AG stated that it is possible for the Member States to apportion tax jurisdiction between them and even the priority to tax.³¹⁰ It was possible for the Member States to ensure the fulfilment of its obligations stemming from the free movement provisions in the EC Treaty by the application of provisions in a DTC, if the treatment of non-residents were in its actual effect equal to the treatment of residents.³¹¹ The burden rested on the Member State whose provisions were discriminatory when disregarding the effects of the DTC.³¹² The application of these principles in the case at hand lead the AG to conclude that France failed to grant non-residents relief for the double economic taxation imposed by it, which was of the same character as for resident parent companies.³¹³

5.3.2.6.2 Judgement by the ECJ

The Court started by stating that although the residence of a taxpayer may constitute a factor that might justify different treatment as regards tax law, the Member State may not do so when residents and non-residents were in a comparable situation.³¹⁴ It noticed thereafter that dividends paid by subsidiaries resident in France to a resident parent company was almost exempt from withholding tax, as where a payment from a resident to a non-

³⁰⁴ Opinion by AG Geelhoed in Denkavit, para. 7

³⁰⁵ Opinion by AG Geelhoed in Denkavit, para. 8

³⁰⁶ Opinion by AG Geelhoed in Denkavit, para. 9

³⁰⁷ Opinion by AG Geelhoed in Denkavit, para. 21

³⁰⁸ Opinion by AG Geelhoed in Denkavit, para. 23

³⁰⁹ Opinion by AG Geelhoed in Denkavit, para. 25-29

³¹⁰ Opinion by AG Geelhoed in Denkavit, para. 34

³¹¹ Opinion by AG Geelhoed in Denkavit, para. 40-42

³¹² Opinion by AG Geelhoed in Denkavit, para. 43

³¹³ Opinion by AG Geelhoed in Denkavit, para. 46-52

³¹⁴ Judgement by the ECJ in Denkavit, para. 23-24

resident was subject to such withholding tax.³¹⁵ This treatment was found to create a restriction.³¹⁶ The arguments put forward by the French government in order to try to justify the national legislation was rejected due to the fact that, even though a distribution made by a resident company to a resident shareholder may not be comparable to a distribution made cross border, the situations became comparable when the state imposed tax on income not only for residents but also for non-residents.³¹⁷ The Court held that non-residents receiving dividends were in the same situation as residents when they both receive dividends from a French subsidiary and since France had chosen to relieve its residents from the effect of the imposed economic double taxation, it had to extend this benefit to non-resident shareholders.³¹⁸

The Court then considered the implications of the applicable DTC. It held that it had to take it into account and also that, even though the Member States remained at liberty to allocate their taxing powers, they may not disregard Community law when doing so.³¹⁹ The Court found however that, even though the withholding tax was limited to 5 %, the application of the DTC together with the national legislation did not remove the restrictive effects that the Court had found to exist in the national legislation.³²⁰

5.3.2.6.3 Comments

It is possible to derive from this case that outbound dividend payments to non-residents, when they were in a comparable situation to residents, may not be subject to a tax that was not levied in respect of dividend payments made domestically.³²¹ The fact that the Court distinguished this case from the ACT Test Claimants case had been criticized by some and defended by others.³²²

5.3.2.7 Amurta

5.3.2.7.1 Opinion by the AG

This case concerned the Dutch legislation, which at the time prescribed that a withholding tax was to be levied on the distribution of shares at a rate of 25 %.³²³ No withholding tax was levied however if a participation exemption was applicable or if, due to the implementation of the Parent-Subsidiary directive, the shareholder was established in the EU and held at least 25 % of the capital or, if the state in which the shareholder was established applied a threshold of 10 %, the Dutch legislation extended the exemption to such a holding.³²⁴ According to the Dutch law on corporation tax, the participation exemption was applicable to holdings of at least 5 % in the

³¹⁵ Judgement by the ECJ in *Denkavit*, para. 27

³¹⁶ Judgement by the ECJ in *Denkavit*, para. 28-30

³¹⁷ Judgement by the ECJ in *Denkavit*, para. 34-35

³¹⁸ Judgement by the ECJ in *Denkavit*, para. 36-37

³¹⁹ Judgement by the ECJ in *Denkavit*, para. 43-45

³²⁰ Judgement by the ECJ in *Denkavit*, para. 46-56

³²¹ *Terra/Wattel* (2008), p. 827

³²² *Graetz/Warren* (2007), pp. 1615-1616; *Lang* (2008), p. 72; *Vanistendael* (2007), p. 212; see chapter 3.1, p. 16

³²³ Opinion by AG Mengozzi in *Amurta*, para. 5

³²⁴ Opinion by AG Mengozzi in *Amurta*, para. 7-8

nominal capital of the company.³²⁵ Further, the applicable DTC provided that the state in which the shareholder was resident had the right to tax dividends received by the shareholder from a company resident in the other contracting state; the state in which the company was a resident had however a right to tax the distribution of dividends at a rate of 10 % of the gross amount.³²⁶ According to the applicable DTC, Portugal agreed that the tax levied in the Netherlands on dividends distributed to Portuguese residents was to be deducted up to the amount of the Portuguese tax that would have been payable on such dividends.³²⁷

In this case, a Portuguese company (Amurta) held 14 % of the capital in a Dutch company (Retailbox BV), with one other Dutch company and two Portuguese companies being shareholders (66, 14 and 6 % respectively).³²⁸ Retailbox made a distribution of dividends to its shareholder on which it withheld 25 % by way of tax, except in respect of the Dutch shareholder.³²⁹ Retailbox, on behalf of Amurta, objected to the withholding tax but the tax inspector rejected that objection; his decision was appealed against.³³⁰

The AG held that, since the Dutch legislation prescribed different thresholds for the exclusion of the liability to withholding tax on dividends depending on if the company was a resident or a non-resident, there was a difference in treatment.³³¹ The AG moved on to state that even if the situations of a resident and a non-resident may not as such be comparable, they might be so if there was no objective difference between them as to the way they were treated by the tax law of the Member State.³³² Thus, as the Court had previously held, the situations might be comparable when a state was acting in a source state capacity and had chosen to exercise its right to tax in a way that made no difference between residents and non-residents. If so, that state had to extend the tax benefits granted to residents also to non-residents, insofar as they were affected by the taxes in the same way.³³³ That was not provided for in the national legislation and thus the AG held that the Dutch legislation constituted discrimination.³³⁴ He then rejected the arguments put forward in order to justify the Dutch legislation, which was based on the fact that the difference in treatment was created by the allocating of taxing powers legitimately exercised by the Member States and the need to preserve the cohesion of the Dutch tax system.³³⁵ Both of these arguments were however rejected. The first one because even if the Member States had the liberty to choose how to relieve double taxation, they have to comply with Community law when doing so and that had not been done in this

³²⁵ Opinion by AG Mengozzi in Amurta, para. 9

³²⁶ Opinion by AG Mengozzi in Amurta, para. 10-11

³²⁷ Opinion by AG Mengozzi in Amurta, para. 12

³²⁸ Opinion by AG Mengozzi in Amurta, para. 13

³²⁹ Opinion by AG Mengozzi in Amurta, para. 14

³³⁰ Opinion by AG Mengozzi in Amurta, para. 15-16

³³¹ Opinion by AG Mengozzi in Amurta, para. 26

³³² Opinion by AG Mengozzi in Amurta, para. 35-36

³³³ Opinion by AG Mengozzi in Amurta, para. 43-44

³³⁴ Opinion by AG Mengozzi in Amurta, para. 45-46

³³⁵ Opinion by AG Mengozzi in Amurta, para. 47 and 56

case.³³⁶ The second argument was rejected due to the fact that, even if the Court did soften the requirements for the application of this ground for justification in *Manninen*, the AG thought that the Netherlands government had not shown him how the cohesion of the Dutch tax system would be in danger if the exemption had to be granted to non-residents, who were in a comparable situation.³³⁷

The AG assessed whether this difference in treatment could be neutralized by benefits in another state or by the application of the relevant DTC. The first question was answered in the negative.³³⁸ As for the second question, the AG held that the DTC had to be taken into account since it provided a view of the economic reality of the taxpayer and also a chance to see if the Member State had complied with Community law by appropriately allocating the powers of taxation.³³⁹ To comply with Community law, the DTC should provide compliance in concrete terms and the duty to neutralize the distorting effects lied on the faulting Member State.³⁴⁰ It was held that it was for the national Court to see if the overall treatment of non-residents was in compliance with Community law. The AG arrived at the conclusion that the distorting effects could only be overcome if the applicable DTC provided a full tax credit for taxes paid in the Netherlands.³⁴¹ However, in the case, only a partial credit was granted.³⁴²

5.3.2.7.2 Judgement by the ECJ

The Court held that the Member States remained at liberty to choose how to eliminate economic double taxation.³⁴³ However, the Court found that the Dutch legislation made a difference between shareholders with a holding between 5 and 25 % when they received dividends from a Dutch company based on if they had residence in the Netherlands or not.³⁴⁴ This difference in treatment constituted a restriction on the free movement of capital.³⁴⁵

The Court further held that non-residents and residents were in a comparable situation because, even if they were not comparable as such, the Netherlands had chosen to exercise its right to tax at source in respect of non-residents in a way that resembles the way that residents were taxed and thus residents and non-residents were in a comparable situation.³⁴⁶ In this situation, the Netherlands was under an obligation to extend the benefit of relieving the economic double taxation created by it to non-residents in the same manner as done for residents; the Netherlands had however chosen not to do so.³⁴⁷

³³⁶ Opinion by AG Mengozzi in *Amurta*, para. 51-54

³³⁷ Opinion by AG Mengozzi in *Amurta*, para. 62 and 66-67

³³⁸ Opinion by AG Mengozzi in *Amurta*, para. 78

³³⁹ Opinion by AG Mengozzi in *Amurta*, para. 80

³⁴⁰ Opinion by AG Mengozzi in *Amurta*, para. 81

³⁴¹ Opinion by AG Mengozzi in *Amurta*, para. 87 and 90

³⁴² Opinion by AG Mengozzi in *Amurta*, para. 88

³⁴³ Judgement by the ECJ in *Amurta*, para. 24

³⁴⁴ Judgement by the ECJ in *Amurta*, para. 27

³⁴⁵ Judgement by the ECJ in *Amurta*, para. 2428

³⁴⁶ Judgement by the ECJ in *Amurta*, para. 37-39

³⁴⁷ Judgement by the ECJ in *Amurta*, para. 40

The Court rejected all the grounds put forward for the justification of the national legislation. The ground based on the need to preserve the cohesion of the Dutch tax system was rejected since the Court thought that it had not been shown how the granting of the benefit of exemption from withholding tax on dividends for non-residents would endanger the cohesion of the national tax system and thus, the Court could not find a direct link between the fiscal advantage and the offsetting tax levy.³⁴⁸ The argument based on the need to safeguard the allocation of the power to tax between the Member States was also rejected.³⁴⁹ The Court found in the end that even if the existence of other tax advantages could not justify the Dutch legislation, the obligations under the EC Treaty might be complied with due to the application of a DTC.³⁵⁰ In the current proceedings, there had not been a reference to the relevant provisions in the applicable DTC and the Court thus concluded that it was for the national court to find those and assess whether the restriction that had been found to exist was neutralized by its application.³⁵¹

5.3.2.7.3 Comments

The national legislation applicable to the issue in this case was held to constitute a restriction, since the legislation applied differently based on where the recipient was resident. And even though residents and non-residents were not in a comparable situation as such, the situations of the two became comparable when the Netherlands made the choice to exercise its taxing jurisdiction in respect of non-residents. In such a situation, the Netherlands became obliged to extend benefits granted to residents also to non-residents. It also held that the obligation under the EC Treaty might be complied with the application of the relevant DTC.

An opinion has been advanced that the holding by the ECJ in *Amurta* has given the Member States the opportunity to comply with the ECJ Treaty and attain the same economic effects that previously has been struck down by the Court, just by redesigning their tax system.³⁵²

5.3.2.8 Aberdeen

5.3.2.8.1 Opinion by the AG

According to the Finnish legislation on the taxation of corporate income, foreign companies had a limited liability to tax in Finland, which meant that they were liable to tax for income considered to be sourced in Finland and that was, for example, dividends paid by a limited liability company resident in Finland.³⁵³ A company, which was limited liable to tax in Finland, should withhold tax on dividends distributed by it, unless that distribution was made to a company with residence in another Member State of the EU and

³⁴⁸ Judgement by the ECJ in *Amurta*, para. 50-51

³⁴⁹ Judgement by the ECJ in *Amurta*, para. 58-59

³⁵⁰ Judgement by the ECJ in *Amurta*, para. 75-79

³⁵¹ Judgement by the ECJ in *Amurta*, para. 81-83

³⁵² *Terra/Wattel* (2008), pp. 828-829; compare to *Bellingwout* (2008), pp. 131-132

³⁵³ Opinion by AG Mazák in *Aberdeen*, para. 7-8

that company was included in article 2 of the Parent-Subsidiary directive.³⁵⁴ A company with residence in Finland was not liable to tax on income in the form of dividends, but dividends received by a natural person were.³⁵⁵

The proceedings concerned a Finnish limited liability company, Alpha, that was about to become a wholly owned subsidiary of a Luxembourgian SICAV company and asked for a preliminary ruling on the question if Alpha was obliged to withhold tax on dividends paid to the Luxembourgian company.³⁵⁶ It was held that Alpha was obliged to do so; this decision was appealed against.³⁵⁷

After concluding that the provisions of the EC Treaty were applicable and not those in the Parent-Subsidiary directive and that the freedom of establishment was going to provide the ground for assessment, the AG moved on to assess the Finnish legislation.³⁵⁸ He thought that the Finnish legislation created a difference in treatment insofar as dividends distributed between two Finnish companies were not subject to tax, as compared to the taxation of dividends distributed by a Finnish company to a non-resident company that did not hold at least 20 % of the capital of the distributing company or was mentioned in article 2 of the Parent-Subsidiary directive.³⁵⁹ He thereafter held that even though the Finnish legislation created a difference in treatment, such difference in treatment could only be said to constitute discrimination if the same rules were applied in different situations or when different rules were applied in the same situation.³⁶⁰ To assess if the situations were comparable, the AG relied on the findings in *Amurta* rather than *Denkavit*.³⁶¹ From *Amurta*, the AG derived that even if the Member States remained at liberty to choose how to relieve economic double taxation on holdings falling outside the scope of the Parent-Subsidiary directive, they had to comply with the provisions in the EC Treaty when doing so.³⁶²

The AG held, that since Finland had chosen to make non-resident companies liable to corporate income tax in the same manner as Finnish companies, the situation of non-resident companies had become so much alike the treatment of residents that the situations must be held to be comparable to each other.³⁶³ According to the Finnish legislation, in order to avoid economic double taxation, dividends distributed to Finnish parent companies or parent companies falling within the scope of the Parent-Subsidiary directive were not liable to withholding tax, whereas other non-residents were.³⁶⁴ As the AG had held that the situations were comparable to each other, the benefits granted to residents of relieving the economic double taxation arising had to be extended to non-residents insofar as they were liable to tax in Finland in a manner comparable to residents due to the

³⁵⁴ Opinion by AG Mazák in *Aberdeen*, para. 10

³⁵⁵ Opinion by AG Mazák in *Aberdeen*, para. 11

³⁵⁶ Opinion by AG Mazák in *Aberdeen*, para. 12

³⁵⁷ Opinion by AG Mazák in *Aberdeen*, para. 14-16

³⁵⁸ Opinion by AG Mazák in *Aberdeen*, para. 24 and 27

³⁵⁹ Opinion by AG Mazák in *Aberdeen*, para. 30

³⁶⁰ Opinion by AG Mazák in *Aberdeen*, para. 32

³⁶¹ Opinion by AG Mazák in *Aberdeen*, para. 34

³⁶² Opinion by AG Mazák in *Aberdeen*, para. 35

³⁶³ Opinion by AG Mazák in *Aberdeen*, para. 37

³⁶⁴ Opinion by AG Mazák in *Aberdeen*, para. 37 and 39-40

choice made by Finland to extend its taxing jurisdiction to non-residents.³⁶⁵ By not doing so, the Finnish legislation had created a difference in treatment between companies that were in a comparable situation when they were distributing dividends from Finland and thus a discrimination based on the ground of residence had arisen.³⁶⁶ This could not be justified by the fact that SICAV companies were exempt from corporate income tax in Luxemburg, since a difference in tax treatment constituting a discrimination against a fundamental freedom could not be justified by the existence of other advantages in tax treatment.³⁶⁷

5.3.2.8.2 Comments

The AG held in his opinion that the fact the Finnish legislation created a difference in treatment as it prescribed that outbound dividend payments falling outside the scope of the Parent-Subsidiary directive was subject to a withholding tax, whereas domestic distributions were not. An interesting aspect of this case is that the receiving company was a Luxembourgian SICAV company, which was exempt from corporation tax in Luxemburg. As the purpose of the Finnish legislation was to eliminate economic double taxation for all legal persons, the exemption from corporation tax for the SICAV company didn't matter.³⁶⁸ It will however be interesting to see how the ECJ deal with the issue if the purpose to relieve double taxation is limited to certain legal persons.³⁶⁹

5.3.3 Inbound dividend payments

5.3.3.1 St Gobain

5.3.3.1.1 Opinion by the AG

This case concerned a German branch (Saint-Gobain ZN) of a French company (Saint-Gobain SA). The branch was treated as a permanent establishment for income tax purposes and it was subject to limited tax liability in Germany, which included income received by the branch and assets held by that branch.³⁷⁰ The branch had holdings in one American company (about 10 %) and in two German companies (about 99 % in each), which in turn had two and one subsidiary respectively.³⁷¹ Due to the fact that the two German subsidiaries had concluded an agreement with the German branch that they were to be treated as a single entity for income tax purposes, income received from foreign sub-subsidiaries were viewed as taxable directly in the hands of the German branch.³⁷²

The German tax authorities did not grant the German branch an exemption in respect of dividends received from the US and Switzerland,

³⁶⁵ Opinion by AG Mazák in Aberdeen, para. 41

³⁶⁶ Opinion by AG Mazák in Aberdeen, para. 42

³⁶⁷ Opinion by AG Mazák in Aberdeen, para. 43

³⁶⁸ Helminen (2008), p. 357

³⁶⁹ Molander/Wijk (2009), p. 219

³⁷⁰ Opinion by AG Mischo in Saint-Gobain, para. 2

³⁷¹ Opinion by AG Mischo in Saint-Gobain, para. 3

³⁷² Opinion by AG Mischo in Saint-Gobain, para. 4

provided for in the applicable DTCs and although it granted a credit against the corporation income tax for the tax withheld at source in the states where the companies were resident, it did not grant a credit for the tax paid on the profits distributed by foreign subsidiaries and sub-subsidiaries in the states in which they were established.³⁷³ Further, the tax authorities did not grant the German branch an international group relief, which was available to German companies limited by shares that directly held a share in the capital of a foreign subsidiary.³⁷⁴ The German branch objected to these holdings.

The AG noticed as a preliminary point that the unfavourable treatment would not have risen if the company had been a resident in Germany for income tax purposes.³⁷⁵ The AG thereafter held that it existed a discrimination based on the nationality of the parent company in all of the three situations referred to by the German branch.³⁷⁶ The possibility of enjoying the benefits of the international group relief as concerns both income and capital tax and the enjoyment of the indirect tax credit was reserved for companies with residence in Germany.³⁷⁷

The AG moved on to hold that the situations of a resident and a non-resident were comparable since the issue in the case was the taxation of certain shareholdings and those objects were liable to German tax irrespective of whether the taxable person was a resident or non-resident.³⁷⁸ Any advantages connected to this liability had thus to be granted to non-residents in the same way as to residents and any difference in treatment had to be justified.³⁷⁹ However the AG could not find any ground for justification of the national legislation advanced to be applicable and thus articles 52 and 58 EC precluded the national legislation.³⁸⁰

5.3.3.1.2 Judgement by the ECJ

The Court held that the situation concerned the fact that companies operating in Germany in the legal form of a branch were not granted certain tax concessions that was granted to companies subject to unlimited tax liability in Germany.³⁸¹ The granting of these tax concessions was held to be an advantage for those companies who enjoyed them since the application of the concessions resulted in a reduced tax burden; thus non-residents enjoyed a less favourable treatment.³⁸² This difference in treatment was held to constitute a restriction on the freedom to choose the form of a secondary establishment and contrary to both article 52 and 58 EC.³⁸³

The Court then held that, as concerned the receiving of dividends in Germany by a branch of a foreign company or a company resident in Germany, they were in a comparable situation, since they were both liable to

³⁷³ Opinion by AG Mischo in Saint-Gobain, para. 6 and 10

³⁷⁴ Opinion by AG Mischo in Saint-Gobain, para. 11-12

³⁷⁵ Opinion by AG Mischo in Saint-Gobain, para. 28

³⁷⁶ Opinion by AG Mischo in Saint-Gobain, para. 32-37

³⁷⁷ Opinion by AG Mischo in Saint-Gobain, para. 34-36

³⁷⁸ Opinion by AG Mischo in Saint-Gobain, para. 49-50

³⁷⁹ Opinion by AG Mischo in Saint-Gobain, para. 51 and 54

³⁸⁰ Opinion by AG Mischo in Saint-Gobain, para. 59-61, 66-70, 85

³⁸¹ Judgement by the ECJ in Saint-Gobain, para. 36

³⁸² Judgement by the ECJ in Saint-Gobain, para. 38

³⁸³ Judgement by the ECJ in Saint-Gobain, para. 43

German income tax and that shareholdings in subsidiaries or sub-subsidiaries were taxed in Germany.³⁸⁴ The Court also rejected arguments concerning the loss of revenue and the offsetting of the disadvantages by other advantages.³⁸⁵ The Court held that the Member States remained at liberty to reduce the effects of or eliminate economic double taxation, but when doing so they has to comply with Community law.³⁸⁶ The Court also held that the benefits granted to residents of a Member State in a DTC concluded with a third state had to be extended to permanent establishments or non-resident companies established in that Member State by virtue of the national treatment principle.³⁸⁷ It did not see how the balance and the reciprocity of the DTC would be called into question by the extension of the group of recipients of the tax advantage contained in the DTC.³⁸⁸ The Court thus held that articles 52 and 58 EC precluded the national legislation in the proceedings.³⁸⁹

5.3.3.1.3 Comments

The Court held in this case that a branch of a foreign company, subject to a limited tax liability, and a resident company, subject to an unlimited tax liability were in a comparable situation and the tax concession that was granted to resident companies must also be granted to domestic branches of foreign companies. The Member States must thus grant resident legal persons the same tax benefits, irrespective if the person is subject to a limited or an unlimited liability to tax in that state. The Court also held that state in which the branch was resident had to grant it benefits contained within a DTC concluded by the state and a third state, by virtue of the national treatment principle.

The holding by the ECJ in this case has been subject to criticism, as it allegedly failed to consider the whole chain of events in respect of the distribution.³⁹⁰

5.3.3.2 Verkooijen

5.3.3.2.1 Opinion by the AG

The legislation called into question in this case was the Dutch legislation that prescribed that natural persons were exempted from income tax on dividends received up to a certain amount.³⁹¹ However, the withholding tax on dividends was only charged on distributions by companies established in the Netherlands, which resulted in that the exemption provided for natural person only applied on dividends distributed by companies established in the Netherlands.³⁹²

³⁸⁴ Judgement by the ECJ in Saint-Gobain, para. 47

³⁸⁵ Judgement by the ECJ in Saint-Gobain, para. 50 and 53

³⁸⁶ Judgement by the ECJ in Saint-Gobain, para. 56-57

³⁸⁷ Judgement by the ECJ in Saint-Gobain, para. 58

³⁸⁸ Judgement by the ECJ in Saint-Gobain, para. 59

³⁸⁹ Judgement by the ECJ in Saint-Gobain, para. 63

³⁹⁰ Ibid.

³⁹¹ Opinion by AG La Pergola, in Verkooijen, para. 3

³⁹² Ibid.

Mr Verkooijen resided at the relevant time in the Netherlands, where he worked for a Dutch company that was owned indirectly by a Belgian company.³⁹³ He acquired shares in the Belgian company in the context of a company savings plan and those shares later yielded dividends.³⁹⁴ Belgian tax was withheld at source but the main issue was that the Dutch tax authorities assessed Mr Verkooijen for income tax without the application of the exemption described above.³⁹⁵ Mr Verkooijen objected to this.³⁹⁶

It must be noticed that one of the relevant Community acts applicable was the directive 88/361/EEC for the implementation of article 67 EC.³⁹⁷ The AG held first that the activities in the corresponding case were within the scope of the term “capital movements” as provided for by the directive and article 67 EC.³⁹⁸ He then held that the Dutch legislation was likely to deter residents from investing their capital abroad, but also to deter foreign companies from investing in the Netherlands due to the fact that their shares would be less attractive for Dutch investors and it would thus be harder for foreign companies to raise capital in the Netherlands.³⁹⁹ The Dutch legislation was held to constitute a restriction.⁴⁰⁰ This restriction was later held by the AG to be applied in a discriminatory manner due to the fact that it made a distinction of the profits yielded based on where the capital was invested and this could not be accepted since the concept of free movement of capital should mean that the place of where capital was invested may not be regarded as a legitimate base for distinction.⁴⁰¹

The AG moved on to assess the grounds put forward to justify the national legislation. The first ground advanced was based on the intention to promote investments of savings in the state and since that argument was of a purely economic nature, the AG rejected it.⁴⁰² However, the AG found the next argument, which was based on the need to preserve the cohesion of the tax system, to justify the national legislation. The AG thought that the link between the exemption from dividend tax provided for and the levying of a dividend tax was direct and then left it for the national court to decide if the national legislation was suitable and proportionate.⁴⁰³ The AG moved on to assess the national legislation in the light of the freedom of establishment and found that the Dutch legislation was applicable in a discriminatory manner, the AG thought that the same line of reasoning was applicable here as advanced when assessing the freedom of movement of capital.⁴⁰⁴

When assessing the issue in the light of the applicable DTC, the AG thought that the restricting effects of the national legislation were extin-

³⁹³ Opinion by AG La Pergola, in Verkooijen, para. 5

³⁹⁴ Ibid.

³⁹⁵ Ibid.

³⁹⁶ Opinion by AG La Pergola, in Verkooijen, para. 6

³⁹⁷ Opinion by AG La Pergola, in Verkooijen, para. 1

³⁹⁸ Opinion by AG La Pergola, in Verkooijen, para. 13

³⁹⁹ Opinion by AG La Pergola, in Verkooijen, para. 14-15

⁴⁰⁰ Opinion by AG La Pergola, in Verkooijen, para. 16

⁴⁰¹ Opinion by AG La Pergola, in Verkooijen, para. 18

⁴⁰² Opinion by AG La Pergola, in Verkooijen, para. 21-22

⁴⁰³ Opinion by AG La Pergola, in Verkooijen, para. 26-27 and 29

⁴⁰⁴ Opinion by AG La Pergola, in Verkooijen, para. 39 and 41-45

guished.⁴⁰⁵ The AG thought that the Dutch tax system taken as a whole were treating a purely internal situation more favourably than a cross border situation, since, in the latter situation, double taxation was avoided entirely contrary to the first, in which double taxation was only relieved partially.⁴⁰⁶ The conclusion was the same for both the freedom of establishment and the freedom of movement of capital.⁴⁰⁷

5.3.3.2.2 Judgement by the ECJ

After concluding that the receiving of shares from a foreign company was covered by the directive 88/361, the Court held that the national legislation in the main proceedings constituted a restriction on capital movements as provided for by the directive, since both the raising of capital by foreign corporations in the Netherlands and the investing by Dutch residents abroad might be dissuaded.⁴⁰⁸ The ECJ then rejected an argument for the justification of the Dutch legislation based on the fact that the national legislation was designed to promote the national economy, since such arguments, which are of a purely economic nature, cannot provide justification.⁴⁰⁹ As concerning the next argument put forward, which was based on the need to preserve the cohesion of the Dutch tax system, it was rejected by the Court since no direct link was found between the exemption of income tax with regard to income from dividends and the taxation of non-resident companies; “they are two different taxes levied on different tax payers”.⁴¹⁰ Neither was arguments based on the loss of revenue and the existence of other advantages accepted by the ECJ.⁴¹¹

5.3.3.2.3 Comments

The ECJ held that the legislation applied by the Netherlands in this case created a restriction on the free movement of capital, as an exemption from income tax on dividends received by natural persons was granted only to dividends received from Dutch companies. It has been argued that the Court failed to recognise the link between the corporation tax and the shareholder tax in this case.⁴¹²

5.3.3.3 Lenz

5.3.3.3.1 Opinion by the AG

This case concerned the Austrian income tax system. That system provided for taxation of resident companies at two levels, first a tax on the revenue was levied at the rate of 34 % and then a tax was levied upon the distribution of dividends.⁴¹³ As concerned the taxation of the shareholders, two

⁴⁰⁵ Opinion by AG La Pergola, in Verkooijen, para. 55

⁴⁰⁶ Ibid.

⁴⁰⁷ Opinion by AG La Pergola, in Verkooijen, para. 55-56

⁴⁰⁸ Judgement by the ECJ in Verkooijen, para. 30 and 34-36

⁴⁰⁹ Judgement by the ECJ in Verkooijen, para. 47-48

⁴¹⁰ Judgement by the ECJ in Verkooijen, para. 57-58

⁴¹¹ Judgement by the ECJ in Verkooijen, para. 59-61

⁴¹² Graetz/Warren (2007), p. 1597

⁴¹³ Opinion by AG Tizzano in Lenz, para. 4

different regimes applied based on the distinction between domestic and foreign investment income. For domestic income, the shareholder could choose between a final tax at a fixed rate of 25 % or the ordinary income tax reduced by 50 %.⁴¹⁴ In the first case, the dividend income would be taxed at 25 % and since that tax was final, it would not be subject to income tax, whereas in the second case, the dividend income would be subject to income tax and to compensate the fact that a higher rate most likely would apply, the dividend income was only taxed at half of the normal income tax rate.⁴¹⁵ This option was however not available for foreign investment income, which in the corresponding case lead to that a German national (Mrs Lenz) residing in Austria, who derived all of her income from investments in Germany, was taxed at the normal income tax rate.⁴¹⁶ Mrs Lenz lodged a complaint against the decision.⁴¹⁷

AG Tizzano held that the national legislation in the main proceedings created a difference in treatment between foreign and domestic income that was likely to dissuade residents of Austria to invest their capital in other Member States and foreign companies from seeking to raise capital in Austria and this difference was held to be a restriction on the free movement of capital.⁴¹⁸

Thereafter, the AG moved on to see whether the national legislation might be justified. However, he did not find the arguments advanced by the different governments convincing. The ground for justification based on the need to preserve the cohesion of the Austrian tax system was rejected by the AG for the same reason the ECJ rejected it in *Verkooijen*; the taxes were separate from each other and was levied on different tax payers.⁴¹⁹ The AG also rejected arguments based on administrative issues and the risk of tax evasion.⁴²⁰

5.3.3.3.2 Judgement by the ECJ

The ECJ found, with the same reasoning as applied by the AG, that the national legislation constituted a restriction on the free movement of capital (see just above).⁴²¹ The Court moved on to assess if the situations of a resident receiving domestic investment income and a resident receiving foreign investment income was comparable to each other. With regard to the fact that the purpose of the Austrian legislation was to ease the double taxation of company profits and since such double taxation may arise both when the revenue was of domestic and when it was of foreign origin, the situations was held to be comparable to each other.⁴²²

The Court rejected the argument advanced to justify the national legislation based on the need to preserve the cohesion of the national tax

⁴¹⁴ Opinion by AG Tizzano in *Lenz*, para. 6

⁴¹⁵ Opinion by AG Tizzano in *Lenz*, para. 7-8

⁴¹⁶ Opinion by AG Tizzano in *Lenz*, para. 9 and 11-13

⁴¹⁷ Opinion by AG Tizzano in *Lenz*, para. 14

⁴¹⁸ Opinion by AG Tizzano in *Lenz*, para. 22-23

⁴¹⁹ Opinion by AG Tizzano in *Lenz*, para. 37-38

⁴²⁰ Opinion by AG Tizzano in *Lenz*, para. 31-34, 39-42 and 43-44

⁴²¹ Judgement by the ECJ in *Lenz*, para. 20-22

⁴²² Judgement by the ECJ in *Lenz*, para. 20-22

system since the taxes concerned were separate from one another and the tax advantages, as concerned the income tax, were not dependent on the taxation of the profits of the corporations.⁴²³ The Court also held that the purpose of the Austrian legislation (see above) would not be affected by the need to extend the enjoying of the concerned benefits to residents deriving income from foreign investments.⁴²⁴ Further, the Court rejected arguments based on the loss of tax revenue, the existence of other advantages and the need to ensure the effectiveness of fiscal supervision.⁴²⁵

5.3.3.3 Comments

The Austrian legislation prescribed that residents receiving domestic investment income could choose between a final tax at 25 % or the ordinary income tax reduced by 50 %. This option was not available for residents receiving inbound dividend payments and this was held by the Court to constitute a restriction. The same argument that has been advanced in respect of the holding by the Court in *Verkooijen*, that the Court failed to recognise the connection between the corporation tax and the shareholder tax, has been advanced in respect of this case.⁴²⁶

5.3.3.4 Manninen

5.3.3.4.1 Opinion by the AG

This case concerned the Finnish legislation on the taxation of income in the form of dividends. In Finland, both the corporation tax and the income tax for individuals stood at a rate of 29 %.⁴²⁷ In order to relieve the recipient of the dividends from double taxation, a tax credit was granted and the dividend and the credit was added together and was then subject to tax.⁴²⁸ The application of this system would result in a full relief for the income tax due on the dividends received.⁴²⁹ However, these rules only applied to resident share companies and fully taxable recipients.⁴³⁰ Due to the fact that Sweden levied a withholding tax on distributions made to non-residents, the application of the Finnish system lead to the result that corporation tax paid in Sweden was not taken into account.⁴³¹

Mr Manninen wanted a preliminary ruling on the question if he was subject to full income tax in Finland on dividends received from shares in a Swedish company. The decision was that he was fully liable to income tax in Finland and he was not entitled to a tax credit.⁴³² This decision was appealed against.

The AG held first that the Finnish legislation eliminated the double taxation arising for purely domestic investments, whereas double taxation

⁴²³ Judgement by the ECJ in *Lenz*, para. 36

⁴²⁴ Judgement by the ECJ in *Lenz*, para. 38

⁴²⁵ Judgement by the ECJ in *Lenz*, para. 40, 43 and 44-48

⁴²⁶ Graetz/Warren (2007), p. 1597

⁴²⁷ Opinion by AG Kokott in *Manninen*, para. 6

⁴²⁸ Opinion by AG Kokott in *Manninen*, para. 6 (see e.g. para. 7)

⁴²⁹ Opinion by AG Kokott in *Manninen*, para. 7

⁴³⁰ Opinion by AG Kokott in *Manninen*, para. 10

⁴³¹ Opinion by AG Kokott in *Manninen*, para. 11-12

⁴³² Opinion by AG Kokott in *Manninen*, para. 13

with regard to foreign investments was not.⁴³³ Even though the withholding tax levied might be offset, the recipient would still be liable to taxation at the rate of 29 % (some in the source state and some in Finland) since he would not be entitled to a tax credit.⁴³⁴ This made it less attractive for Finnish residents to invest abroad and to seek to raise capital in Finland and thus the national legislation constituted a restriction on the free movement of capital.⁴³⁵

AG Kokott moved on to assess whether the situation of a purely domestic distribution and a cross border distribution was comparable. In this regard she stated first that the risk of double taxation was the same in both situations since both distributing companies would be subject to corporation tax and the recipients to income tax.⁴³⁶ The only difference was that, in one case, there were two taxing jurisdiction involved and in the latter, only one.⁴³⁷ If the Member States wanted to achieve the purpose of relieving double taxation, they had to coordinate the taxation of the two taxpayers and make sure that the purpose was achieved also for residents receiving dividends from non-resident companies.⁴³⁸

The AG moved on to assess whether the national legislation might be justified by the need to preserve the cohesion of the tax system. In her assessment, she proposed that the requirements for the application of this ground for justification that had been outlined by the Court in its case law should be eased. Kokott proposed that a link between the advantage and the tax levied should be held to be direct if the tax was levied on at least the same income or economic process and if the advantage of the taxpayer was accrued to him only if the disadvantage of the other taxpayer was real and in the same amount.⁴³⁹ This would, according to AG Kokott, be just as effective as the old application of the argument, which was limited to taxes levied on one and the same taxpayer.⁴⁴⁰ Since the Finnish legislation met these conditions, the argument based on the cohesion of the tax system did not fail due to the fact that the issue in the case concerned two taxpayers.⁴⁴¹ However, when assessing this argument further, the AG came to the conclusion that the Finnish legislation went farther than necessary when it excluded the possibility of offsetting foreign corporation tax paid; she thought that at least tax actually paid per share should be able to be offset.⁴⁴² Thus, in rejecting this argument, she held the national legislation to be precluded by articles 56 and 58 EC.⁴⁴³

⁴³³ Opinion by AG Kokott in Manninen, para. 30

⁴³⁴ Opinion by AG Kokott in Manninen, para. 31

⁴³⁵ Opinion by AG Kokott in Manninen, para. 32-33

⁴³⁶ Opinion by AG Kokott in Manninen, para. 44

⁴³⁷ Opinion by AG Kokott in Manninen, para. 45

⁴³⁸ Opinion by AG Kokott in Manninen, para. 46

⁴³⁹ Opinion by AG Kokott in Manninen, para. 61

⁴⁴⁰ Opinion by AG Kokott in Manninen, para. 62

⁴⁴¹ Opinion by AG Kokott in Manninen, para. 64-65

⁴⁴² Opinion by AG Kokott in Manninen, para. 78

⁴⁴³ Opinion by AG Kokott in Manninen, para. 80

5.3.3.4.2 Judgement by the ECJ

The ECJ noticed that the national legislation was designed to eliminate the economic double taxation that would arise due to the fact that the profits of the companies were taxed both in the hands of the company and in the hands of the shareholder, when the profits were distributed.⁴⁴⁴ The system provided for the offsetting of the corporation tax paid on the dividends received and the results of this system was that the dividends were not taxed in the hands of the shareholder.⁴⁴⁵ However, this benefit was only applicable when resident companies distributed dividends and thus the national legislation was likely to deter residents from investing abroad and foreign companies from seeking to raise capital in Finland.⁴⁴⁶ The Court held that the national legislation constituted a restriction on the free movement of capital.⁴⁴⁷

The Court moved on to examine if the national legislation could be justified. When doing so, it looked to the provisions of the EC Treaty and examined articles 56 and 58 EC, in particular 58(1)(a) and 58(3) EC. The Court held first that article 58(1)(a) EC must be interpreted strictly and the difference in treatment had to concern situations that was not comparable to each other or justified by overriding reasons in the general interest.⁴⁴⁸

As regards the comparability, the Court noticed that both dividends from a resident and a non-resident company were able to be subject to double taxation and, with regard to the fact that the legislation took corporate tax paid into account when seeking to relieve double taxation, shareholders resident in Finland and receiving dividends from a resident and a non-resident company respectively were held to be in a comparable situation.⁴⁴⁹ It rejected an argument advanced based on the principle of territoriality.⁴⁵⁰

When assessing the argument advanced based on the need to preserve the cohesion of the Finnish tax system, the Court found a link between the tax advantage and the tax levied but it thought that the Finnish legislation went farther than necessary.⁴⁵¹ The Court thought that the cohesion of the tax system would be preserved if the Finnish resident were granted a tax credit for the tax owed by the non-resident company.⁴⁵² The reduction in tax revenue, which would follow from the extension of the tax credit, could not justify this kind of restriction.⁴⁵³ An argument based on the problems in determining tax actually paid, to which the Finnish tax credit related, was also rejected.⁴⁵⁴

⁴⁴⁴ Judgement by the ECJ in Manninen, para. 20

⁴⁴⁵ *Ibid.*

⁴⁴⁶ Judgement by the ECJ in Manninen, para. 20-23

⁴⁴⁷ Judgement by the ECJ in Manninen, para. 24

⁴⁴⁸ Judgement by the ECJ in Manninen, para. 29

⁴⁴⁹ Judgement by the ECJ in Manninen, para. 35-37

⁴⁵⁰ Judgement by the ECJ in Manninen, para. 38-39

⁴⁵¹ Judgement by the ECJ in Manninen, para. 45

⁴⁵² Judgement by the ECJ in Manninen, para. 46

⁴⁵³ Judgement by the ECJ in Manninen, para. 49

⁴⁵⁴ Judgement by the ECJ in Manninen, para. 53-54

5.3.3.4.3 Comments

The imputation system applied by Finland in this case had as a purpose to relieve economic double taxation arising due to the fact that the profit of corporations were taxed both in the hands of the corporation and, when it was distributed, in the hands of the shareholder. This purpose was attained due to fact that the shareholder was granted an imputation credit when he received a dividend from a domestic company in respect of the corporation tax already paid. This imputation credit was not granted to residents receiving inbound dividend payments from another state. This created a restriction according to the Court.

An interesting aspect is found in the opinion given by AG Kokott, in which she elaborated on the criteria for the application of the need to preserve the cohesion of the tax system as an argument able to justify a restriction. This case has been praised in the literature as the Court successfully considered the whole chain of events from the distributor to the recipient of the dividend.⁴⁵⁵ It has also been argued that the holding in *Orange Small Cap* has set the holding by the Court in *Manninen* aside.⁴⁵⁶

5.3.3.5 Kerckhaert Morres

5.3.3.5.1 Opinion by the AG

This case concerned the relations between the Belgian and the French tax systems, but the Belgian system in particular. At the time, France, with the objective to eliminate double taxation, applied an imputation system, which meant that shareholders liable to tax on dividends received were granted a tax credit for the corporation tax paid in respect of dividends.⁴⁵⁷ Due to the application of the relevant DTC, such a tax credit was also granted to Belgian residents receiving dividends from companies resident in France.⁴⁵⁸ If the Belgian recipient wasn't liable to corporation tax and the dividends had been subject to withholding tax in France, the Belgian tax due on the net amount had to be reduced by a withholding tax at a normal rate and a fixed quota of the foreign tax.⁴⁵⁹ Belgium applied a schedular system, which meant that all income was considered together and subject to a progressive tax, but a special regime was available under which dividends were taxed at a fixed rate of 25 %.⁴⁶⁰

In 1995 and 1996, two Belgian residents received dividends from France, on which they were granted a tax credit; this was treated as a dividend under the DTC and thus a French withholding tax was deducted.⁴⁶¹ When the residents declared this income, they claimed the imputation of the fixed quota of foreign tax mentioned above.⁴⁶² However, the revenue was

⁴⁵⁵ Graetz/Warren (2007), p. 1597

⁴⁵⁶ Spaas (2009), p. 63

⁴⁵⁷ Opinion by AG Geelhoed in *Kerckhaert Morres*, para. 3

⁴⁵⁸ Opinion by AG Geelhoed in *Kerckhaert Morres*, para. 4

⁴⁵⁹ Opinion by AG Geelhoed in *Kerckhaert Morres*, para. 5

⁴⁶⁰ Opinion by AG Geelhoed in *Kerckhaert Morres*, para. 6

⁴⁶¹ Opinion by AG Geelhoed in *Kerckhaert Morres*, para. 8-9

⁴⁶² Opinion by AG Geelhoed in *Kerckhaert Morres*, para. 10

taxed at a rate of 25 % and no imputation of the fixed quota was granted; the two residents appealed against this decision.⁴⁶³

As the AG assessed the national legislation in the light of the freedom of establishment, he noticed that the Court had held this provision prohibits restrictions that was not just a result of the fact that the tax systems are national, unless justified and proportionate.⁴⁶⁴ He also noticed that different obligations arise whether the Member State acts in a source state or, as Belgium in this case, as a home state.⁴⁶⁵ The AG found that the Belgian legislation did not directly discriminate between foreign and domestic sourced income, since all dividends were subject to the special tax rate.⁴⁶⁶ The AG also made a distinction between this case and cases such as Manninen and Verkooijen, since the issue in those cases were that the national legislation did not extend the benefit of relieving double taxation to foreign sourced dividends, but, as in this case, all dividends were subject to tax in the hands of the shareholder after first being subject to corporation income tax, domestic or foreign.⁴⁶⁷

The AG moved on to see if the national legislation was indirectly discriminatory. The Belgian residents claimed that foreign sourced dividends were treated less favourably than domestic sourced dividends.⁴⁶⁸ On the contrary, the AG found that the actual effect of the application of the French tax system was that foreign sourced dividends were better off than dividends distributed by a Belgian company.⁴⁶⁹ This was due to the fact that also non-residents of France were granted a tax credit, in this case in the amount of 50 % of the dividend, and although both the dividend and the tax credit were subject to a 15 % withholding tax, the net amount received was higher than in a purely domestic situation.⁴⁷⁰ Thus, the AG held that there was no discrimination or restriction against the freedom of establishment.⁴⁷¹

5.3.3.5.2 Judgement by the ECJ

The Court made a distinction between this case and the situations in Verkooijen, Lenz and Manninen. The national legislation in those cases did not treat foreign sourced and domestic sourced income received by residents in the same way, whereas in this case, the national legislation treated foreign and domestic dividends in the same way, they were both subject to tax.⁴⁷² The Court also found that residents were in different situations depending on from where they were receiving dividends and the position of the shareholder wasn't altered only because he received dividends from another Member State who had made such a distribution subject to a deduction at source.⁴⁷³ The Court came to the conclusion that the results in this case was

⁴⁶³ Opinion by AG Geelhoed in Kerckhaert Morres, para. 11-12

⁴⁶⁴ Opinion by AG Geelhoed in Kerckhaert Morres, para. 18

⁴⁶⁵ Opinion by AG Geelhoed in Kerckhaert Morres, para. 19-20

⁴⁶⁶ Opinion by AG Geelhoed in Kerckhaert Morres, para. 21

⁴⁶⁷ Ibid.

⁴⁶⁸ Opinion by AG Geelhoed in Kerckhaert Morres, para. 23

⁴⁶⁹ Opinion by AG Geelhoed in Kerckhaert Morres, para. 25

⁴⁷⁰ Ibid.

⁴⁷¹ Opinion by AG Geelhoed in Kerckhaert Morres, para. 26

⁴⁷² Judgement by the ECJ in Kerckhaert Morres, para. 16-17

⁴⁷³ Judgement by the ECJ in Kerckhaert Morres, para. 18-19

due to the “exercise in parallel by two Member States of their fiscal sovereignty” and thus, the national legislation was held not to be precluded by the EC Treaty.⁴⁷⁴

5.3.3.5.3 Comments

As seen above, the Court held that the differences in treatment in the case existed due to the exercise in parallel by two Member States of their fiscal sovereignty. From this it is possible to infer that there are disparities between the tax systems of the Member States due to the lack of positive integration of the direct taxes and Court has now stated that it cannot deal with these. This argument advanced by the Court has been criticised in the literature.⁴⁷⁵ It has been argued that this case gives the Member States an opportunity to redesign their tax system and still attain the same economic effects, but at the same time praised as the holding by the Court was correct in principle.⁴⁷⁶

5.3.3.6 FII Test Claimants

5.3.3.6.1 Opinion by the AG

The issues in this case arose in the same legislative context as the issues in *Metallgesellschaft* and the ACT Test Claimants.⁴⁷⁷ I kindly ask the reader to consult these chapters for a presentation of the applicable legislation. However, the two previous cases concerned the tax treatment in the UK of dividends paid by resident companies to non-resident shareholder, whereas this case concerned the tax treatment of dividends received by UK companies from companies resident in other Member States.⁴⁷⁸

However, a presentation has to be made of a scheme called the Foreign Income Dividend Scheme (FID). When UK companies distributed dividends, it could elect that the dividend was a foreign income dividend, which resulted in that, if the company could match the FID with foreign profits, the company could apply for surplus ACT arising in respect of the FID; however, ACT was due on a FID.⁴⁷⁹ It didn't constitute a franked investment income and the shareholder receiving the dividend was not entitled to a tax credit.⁴⁸⁰

The first issue were if it was compatible with article 43 EC, for a Member State exercising home state jurisdiction, to relieve economic double taxation on dividends by using the exemption method for domestic sourced dividends and the credit method for foreign sourced dividends.⁴⁸¹ The AG split his assessment into two parts based on whether the holding

⁴⁷⁴ Judgement by the ECJ in *Kerckhaert Morres*, para. 20 and 24; see also para. 21-23 as regards the DTC

⁴⁷⁵ Graetz/Warren (2007), p. 1596

⁴⁷⁶ Terra/Wattel (2008), pp. 812-813

⁴⁷⁷ Chapter 5.3.2.2 and 5.3.2.5 respectively

⁴⁷⁸ Opinion by AG Geelhoed in *FII Test Claimants*, para. 1

⁴⁷⁹ Opinion by AG Geelhoed in *FII Test Claimants*, para. 19

⁴⁸⁰ Opinion by AG Geelhoed in *FII Test Claimants*, para. 20

⁴⁸¹ Opinion by AG Geelhoed in *FII Test Claimants*, para. 41

was no greater than 10 % (portfolio holdings) or if it was no less than 10 % (non-portfolio holdings).⁴⁸²

The AG dealt first with non-portfolio holdings and held that in principle, it was for the Member States to choose how to relieve economic double taxation.⁴⁸³ The application of a credit-based method was thus held to be in consistency with article 43 EC, since, even though the application of the credit method taken together with the UK tax system would result in a higher tax burden on foreign sourced dividends than on domestic sourced, such an effect stems from the disparities of the national tax systems with which article 43 EC is not concerned.⁴⁸⁴ The AG found that the application of a credit-based method when seeking to relieve economic double taxation on foreign sourced dividends could in certain cases lead to a less favourable treatment as compared to domestic sourced dividends, which were subject to the exemption method.⁴⁸⁵ The need to preserve the cohesion of the tax system was not able to justify the national legislation.⁴⁸⁶

As regards portfolio holdings in foreign companies, the AG thought that the UK legislation was discriminatory, since a dividend received by a UK resident due to such a holding was subject to UK corporation tax with credit given only for the withholding tax levied and not the foreign corporation tax, whereas a dividend from a UK portfolio holding was not subject to corporation tax.⁴⁸⁷ An argument put forward for the justification of the provisions based on problems that this would cause regarding the administration and supervision was rejected by the AG.⁴⁸⁸

The next issues dealt with concerned first, the fact that a UK company receiving a dividend from a UK company on which ACT had been paid was able to receive a credit for tax paid whereas a credit was not granted to a UK company receiving a dividend from a non-resident company and second, the fact that foreign corporation tax only was able to be set off against the mainstream corporation tax (MCT) and ACT could only be set off against MCT, which resulted in that UK companies receiving substantial foreign sourced dividend income could have unrelieved ACT.⁴⁸⁹ As regards these issues, AG Geelhoed held first, regarding the fact that the ACT previously had been held by the Court to be an advance payment of UK corporation tax, that UK residents receiving foreign sourced income on which foreign corporation tax had been paid and domestic sourced income respectively were in a comparable situation to each other since both of the distributing companies had been subject to corporation tax.⁴⁹⁰ The AG held that the application of the national provisions mentioned just above meant that it had chosen not to eliminate economic double taxation for foreign sourced income where it had done so for domestic sourced income and that resulted in discrimination, for

⁴⁸² *ibid.*

⁴⁸³ Opinion by AG Geelhoed in FII Test Claimants, para. 43

⁴⁸⁴ Opinion by AG Geelhoed in FII Test Claimants, para. 44-45

⁴⁸⁵ Opinion by AG Geelhoed in FII Test Claimants, para. 50

⁴⁸⁶ Opinion by AG Geelhoed in FII Test Claimants, para. 51-52

⁴⁸⁷ Opinion by AG Geelhoed in FII Test Claimants, para. 53

⁴⁸⁸ Opinion by AG Geelhoed in FII Test Claimants, para. 55

⁴⁸⁹ Opinion by AG Geelhoed in FII Test Claimants, para. 59

⁴⁹⁰ Opinion by AG Geelhoed in FII Test Claimants, para. 69

which the AG found no justification.⁴⁹¹ However, the AG found the provisions to be in breach of article 4(1) in the Parent-Subsidiary directive, not of article 6.⁴⁹²

Another issue was the FID scheme and its compatibility with the provisions of the EC Treaty and the Parent-Subsidiary directive. The AG held that a feature of this scheme, which resulted in that a resident company receiving foreign sourced income was obliged to pay ACT upon redistribution and reclaim it later, was likely to result in a cash-flow disadvantage and thus they were subject to a less favourable treatment.⁴⁹³ Another feature of this scheme, which resulted in that shareholders in UK companies, that had received foreign source dividends, were not granted a tax credit, was held to be in breach of articles 43 and 56 EC since the UK were under an obligation to extend the relief of a tax credit to residents receiving foreign sourced income when it had chosen to do so for domestic sourced income.⁴⁹⁴ The AG didn't find these provisions to be justified.⁴⁹⁵ I would like to add that the AG dealt with other issues, but they will not be dealt with here since they are of no relevance to the subject of this thesis.

5.3.3.6.2 Judgement by the ECJ

The Court dealt first with the issue concerning the application of two different systems when seeking to relieve economic double taxation. It held first that the Member States may choose from a number of systems to do so and these systems might not lead to the same result.⁴⁹⁶ The Court also noticed that article 4(1) of the Parent-Subsidiary directive left it for the Member States to choose between an exemption and a credit system.⁴⁹⁷ Whatever system the Member States had chosen, they might not treat foreign sourced dividends less favourably than domestic sourced dividends, unless they were not in a comparable situation or if such a treatment was justified by overriding reasons in the public interest.⁴⁹⁸ The Court held that it was for the Member States to organize their tax systems, in compliance with Community law, and there was nothing to prevent them from relieving economic double taxation by applying different systems for foreign sourced and domestic sourced income; however, when applying an imputation system in such a situation, the Member State had to prevent the foreign sourced dividends from being subject to a higher tax rate than domestic sourced dividends and make the receiving company able to offset its tax due against the tax paid by the distributing company.⁴⁹⁹

The Court assessed the issue under the free movement of capital. For holdings at 10 % or more, the Court arrived at the same conclusion as for

⁴⁹¹ Opinion by AG Geelhoed in FII Test Claimants, para. 72-79

⁴⁹² Opinion by AG Geelhoed in FII Test Claimants, para. 80-90 and 91

⁴⁹³ Opinion by AG Geelhoed in FII Test Claimants, para. 96

⁴⁹⁴ Opinion by AG Geelhoed in FII Test Claimants, para. 97-100

⁴⁹⁵ Opinion by AG Geelhoed in FII Test Claimants, para. 106

⁴⁹⁶ Judgement by the ECJ in FII Test Claimants, para. 43

⁴⁹⁷ Judgement by the ECJ in FII Test Claimants, para. 44

⁴⁹⁸ Judgement by the ECJ in FII Test Claimants, para. 46

⁴⁹⁹ Judgement by the ECJ in FII Test Claimants, para. 47-50 and 53-57

the freedom of establishment.⁵⁰⁰ For holdings at less than 10 %, the Court held, after first finding that a resident receiving a foreign sourced dividend was in a comparable situation to a resident receiving a domestic sourced dividend, that the UK legislation gave rise to a difference in treatment, which constituted a restriction.⁵⁰¹ An argument put forward for the justification of the national provisions based on practical and administrative issues was rejected by the Court since a restriction against a fundamental freedom was not able to be justified by difficulties to determine tax actually paid in another Member State.⁵⁰²

The fact that only UK resident companies receiving domestic sourced dividends was entitled to a tax credit with which they could offset their own ACT liability was held to, since under such a system ACT was only paid once upon redistribution, constitute a tax flow advantage.⁵⁰³ The Court thereafter rejected an argument advanced based on the fact that the distinction made was not based on nationality but rather on whether ACT had been paid or not. This was based on the fact that ACT was held to only be an advanced payment of UK corporation tax and the purpose of the provisions was to relieve double taxation.⁵⁰⁴ With regard to the purpose, recipients of foreign sourced and domestic sourced dividends were in a comparable situation and due to the character of the ACT, the national provisions as they stood did not consider the fact that also the distributing foreign company had been subject to corporation tax.⁵⁰⁵ The national provision was thus held to be precluded by article 43 EC.⁵⁰⁶ The Court also rejected an argument that relied on the Parent-Subsidiary directive, since it considered the issue to fall outside the scope of articles 4(1) and 6.⁵⁰⁷

Further, the Court held that provisions providing that relief for tax paid abroad given to a UK resident company which had received foreign dividends would reduce the corporation tax against which ACT could be set off was not precluded by the provisions in the EC Treaty; however, a provision providing that surplus ACT in the hands of a resident company could not be surrendered to a foreign company, was held to be precluded.⁵⁰⁸ The Court also rejected the reliance on article 4(1) of the Parent-Subsidiary directive in this case.⁵⁰⁹

On the last issue in the case that will be dealt with in this thesis, concerning the FID regime, the Court held that that regime gave rise to a difference in treatment between UK companies receiving domestic sourced dividends and UK companies receiving dividends from abroad and having elected the FID regime, as they suffered a cash flow disadvantage and did not receive a tax credit.⁵¹⁰ That constituted a restriction according to the

⁵⁰⁰ Judgement by the ECJ in FII Test Claimants, para. 60

⁵⁰¹ Judgement by the ECJ in FII Test Claimants, para. 62 and 63-65

⁵⁰² Judgement by the ECJ in FII Test Claimants, para. 66-71

⁵⁰³ Judgement by the ECJ in FII Test Claimants, para. 82-84

⁵⁰⁴ Judgement by the ECJ in FII Test Claimants, para. 87 and 88

⁵⁰⁵ Judgement by the ECJ in FII Test Claimants, para. 87 and 90-91

⁵⁰⁶ Judgement by the ECJ in FII Test Claimants, para. 94

⁵⁰⁷ Judgement by the ECJ in FII Test Claimants, para. 99-112

⁵⁰⁸ Judgement by the ECJ in FII Test Claimants, para. 120-127 and 129-134

⁵⁰⁹ Judgement by the ECJ in FII Test Claimants, para. 137

⁵¹⁰ Judgement by the ECJ in FII Test Claimants, para. 147-149

Court, for which it did not find any reason that was able to justify the national legislation.⁵¹¹

5.3.3.6.3 Comments

The Member States may apply different methods, either the exemption or the credit method, in respect of residents and non-residents when they seek to eliminate double taxation, as long as it is done in compliance with the EC Treaty. The fact the Court granted the Member States the opportunity to apply different methods in respect of residents and non-residents has been criticized.⁵¹² Another important holding by the Court was that it held that the fact that a tax credit was granted only to UK resident companies when they received domestic sourced dividends and not when the dividends was foreign sourced created a restriction.

It has also been argued that this case, read in conjunction with the ACT Test Claimants case, implies that the Court has chosen to apply the principle of source state entitlement.⁵¹³

5.3.3.7 Meilicke and others

5.3.3.7.1 Opinion by the AG

The national legislation prescribed that German taxpayers were able to set off three sevenths of their dividend income distributed by German companies against their income tax.⁵¹⁴ This resulted in that, since the corporation income tax stood at a rate of 30 %, the profits were not subject to tax twice.⁵¹⁵ This option was not available for residents receiving foreign sourced dividends.⁵¹⁶

A German resident (Mr Meilicke) received dividends from the Netherlands and Denmark in 1995 and 1997.⁵¹⁷ The heirs of Mr Meilicke applied for the extension of the tax credit described above, based on the fact that they thought that this benefit had to be extended due to the ruling by the ECJ in *Verkooijen*; this was however rejected by the German tax authorities.⁵¹⁸

The AG, who relied heavily on the judgement by the ECJ in *Manninen*, held that by not granting residents who received foreign sourced dividends, the German legislation created a restriction on the free movement of capital.⁵¹⁹ The AG found the situations between a resident receiving domestic sourced and foreign sourced income respectively to be in a comparable situation and he rejected an argument based on the need to preserve the cohesion of the tax system, since he thought that the cohesion would be preserved since the tax credit to be granted would be based on the tax actually

⁵¹¹ Judgement by the ECJ in *FII Test Claimants*, para. 154 and 155-172

⁵¹² *Terra/Wattel* (2008), pp. 812-813

⁵¹³ *Graetz/Warren* (2007), p. 1611

⁵¹⁴ Opinion by AG Tizzano in *Meilicke and others*, para. 4

⁵¹⁵ Opinion by AG Tizzano in *Meilicke and others*, para. 5

⁵¹⁶ Opinion by AG Tizzano in *Meilicke and others*, para. 4

⁵¹⁷ Opinion by AG Tizzano in *Meilicke and others*, para. 8

⁵¹⁸ Opinion by AG Tizzano in *Meilicke and others*, para. 9-10

⁵¹⁹ Opinion by AG Tizzano in *Meilicke and others*, para. 20

paid in Denmark and the Netherlands.⁵²⁰ The national legislation was held to be precluded by articles 56 and 58 EC.⁵²¹

5.3.3.7.2 Judgement by the ECJ

The Court held that, when considering that the purpose of the German legislation was to relieve the shareholder of economic double taxation, the fact that the possibility of offsetting the corporation tax paid against the income tax was restricted to dividends distributed by German companies resulted in a less favourable treatment of foreign sourced dividends.⁵²² This fact could deter German residents from investing abroad and foreign companies from seeking investments in Germany.⁵²³

The Court rejected an argument based on the need to preserve the cohesion of the tax system since, although the Court found a link between the tax advantage and the offsetting tax levy, it thought that, with regard to the purpose of the provisions, the cohesion of the tax system would not be threatened by the extension of the benefit of the tax credit to dividends received from foreign companies.⁵²⁴ This conclusion was not altered by the fact that the extension of the benefit might have led to a reduction in tax revenue.⁵²⁵

5.3.3.7.3 Comments

As seen above, the Court held that the German legislation constituted a restriction, as it didn't provide the opportunity for residents receiving foreign sourced dividend income to offset this income against the income tax due, which was available to residents receiving domestic sourced dividend income.

The holding in this case by the Court has been praised in the literature, as the whole chain of events, from the distributor to the recipient of the dividend payment, was considered.⁵²⁶

5.3.3.8 Orange European Small Cap

5.3.3.8.1 Opinion by the AG

This case concerned a Dutch tax regime for so called fiscal investment enterprises (FIE). Companies subject to this regime was liable to corporation tax at 0 %, the profits of the company had however to be distributed to the shareholders within eight months of the end of the tax year.⁵²⁷ When such a company received dividends from a Dutch company, it enjoyed a refund of tax paid on these dividends.⁵²⁸ However, a different method was used when such a company received dividends from a foreign company. On such divi-

⁵²⁰ Opinion by AG Tizzano in Meilicke and others, para. 21 and 25

⁵²¹ Opinion by AG Tizzano in Meilicke and others, para. 30

⁵²² Judgement by the ECJ in Meilicke and others, para. 21-22

⁵²³ Judgement by the ECJ in Meilicke and others, para. 23-24

⁵²⁴ Judgement by the ECJ in Meilicke and others, para. 28-29

⁵²⁵ Judgement by the ECJ in Meilicke and others, para. 30

⁵²⁶ Graetz/Warren (2007), p. 1597

⁵²⁷ Opinion by AG Bot in Orange Small Cap, para. 11

⁵²⁸ Opinion by AG Bot in Orange Small Cap, para. 12

dends, a concession was paid to the company to compensate for issues arising due to the system applied in the Netherlands to eliminate double taxation and the fact that the company was subject to tax at 0%.⁵²⁹ This concession was however subject to limitations insofar as it was only paid if, as concerned direct investments by residents of the Netherlands, the latter would be able to set off the foreign tax and the concession was reduced in line with interest in the capital of the company by shareholders not resident or established in the Netherlands.⁵³⁰

Shareholders in such an enterprise was liable to tax on the distributed profits by way of deduction at source.⁵³¹ Residents or companies established in the Netherlands were able to use this deduction to set off against their income or corporation tax and it was refunded when it exceeded the profits; this was possible for non-residents only if a DTC provided for it or it was provided for in the Dutch law.⁵³²

The company of interest in this case was Orange European Small Cap Fund NV (OES), which under Dutch law was regarded as a FIE and it managed a portfolio of securities issued by listed undertakings in Europe.⁵³³ The shareholders in OES were natural and legal persons that were residents either in other Member States or in third states.⁵³⁴ In the tax year of 1997/1998, OES received dividends on which foreign tax had been deducted at source and it sought a concession for tax paid abroad.⁵³⁵ In the proceedings that followed, questions were being raised concerning this concession.⁵³⁶

After giving a broader outline on certain issues, the AG moved on to assess the first question that concerned the fact that the concession was subject to limitations. The AG held that the fact that economic double taxation had been eliminated for purely domestic distributions and not for foreign sourced dividends paid to a fiscal investment company, which only had a right to a concession, might deter a fiscal investment company from seeking investments abroad and foreign companies from investing in it.⁵³⁷ Further, the AG held that foreign sourced dividends were not treated less favourably than domestic dividends since they were subject to the same treatment both at corporation and at shareholder level.⁵³⁸ He held that the fact that the foreign sourced dividends were subject to a higher tax than domestic sourced dividends in the Netherlands was due to the fact that the states of the distributing companies had chosen to tax the dividends.⁵³⁹ He questioned whether the Netherlands had to extend the entitlement to concession, which was provided for in certain DTCs. After holding that the need to preserve the balance and reciprocity of the commitments in the DTC

⁵²⁹ Opinion by AG Bot in Orange Small Cap, para. 14-15

⁵³⁰ Opinion by AG Bot in Orange Small Cap, para. 17-18

⁵³¹ Opinion by AG Bot in Orange Small Cap, para. 20

⁵³² Opinion by AG Bot in Orange Small Cap, para. 21-22

⁵³³ Opinion by AG Bot in Orange Small Cap, para. 23-24

⁵³⁴ Opinion by AG Bot in Orange Small Cap, para. 25

⁵³⁵ Opinion by AG Bot in Orange Small Cap, para. 26-27

⁵³⁶ Opinion by AG Bot in Orange Small Cap, para. 28-31

⁵³⁷ Opinion by AG Bot in Orange Small Cap, para. 83-83

⁵³⁸ Opinion by AG Bot in Orange Small Cap, para. 87-88

⁵³⁹ Opinion by AG Bot in Orange Small Cap, para. 89

justified the limiting of the entitlement to benefits to the persons covered by them, the AG held that, and referring in part to the judgement by the court in the D case⁵⁴⁰, these interests would not be harmed by the extension of that benefit.⁵⁴¹ Thus, the AG thought that the Netherlands was obliged to extend that benefit to the other Member States.⁵⁴²

Insofar as the national provisions limited the concession granted to the extent of the foreign ownership in the FIE, the AG thought that this limitation was contrary to articles 56 and 58 EC, since the limitation as such restricted the movement of capital and limited the profits available for distribution in an FIE.⁵⁴³ Since all shareholders of a FIE were subject to tax in the Netherlands on received dividends, all shareholders were in a comparable situation.⁵⁴⁴ When the Netherlands decided to tax those taxpayers, irrespective of where they resided or were established, and to grant fiscal investment companies a concession for foreign tax paid, it was obliged to extend the benefit of the concession to companies in which some of the shareholders were non-residents.⁵⁴⁵ The AG held last that the answers would be no different if the tax deducted in another Member State was higher than the tax levied on the distributed dividends.⁵⁴⁶

5.3.3.8.2 Judgement by the ECJ

The Court noticed that it was for the Member States to organize their systems for the taxation of dividends and they were also at liberty to determine how to relieve economic double taxation, as long as they complied with Community law.⁵⁴⁷ Thereafter, the Court stated that companies subject to the FIE scheme were not subject to tax on dividends received, regardless of their origin and thus it treated domestic and foreign sourced dividends in the same way.⁵⁴⁸ The disadvantage that had risen was therefore the result of the taxing of dividends in the state of distribution and the state of residence could not be obliged to offset such a fiscal disadvantage, which had risen due to the imposition of liability to tax in the state of distribution.⁵⁴⁹ Thus, the national provisions in this part were not considered to constitute a restriction.⁵⁵⁰

The Court moved on to assess the issue concerning the concession and the fact the granting of it was subject to limitations. First of all, the Court stated that, as seen above, the Netherlands was under no obligation to grant a concession in order to relieve the disadvantage that existed but where it had chosen to do so, that had to be done in compliance with Community law.⁵⁵¹ The Court also pointed to the fact that it had previously held that,

⁵⁴⁰ Case C-376/03 – “D”

⁵⁴¹ Opinion by AG Bot in Orange Small Cap, para. 104-107

⁵⁴² Opinion by AG Bot in Orange Small Cap, para. 108

⁵⁴³ Opinion by AG Bot in Orange Small Cap, para. 115-118

⁵⁴⁴ Opinion by AG Bot in Orange Small Cap, para. 120

⁵⁴⁵ Opinion by AG Bot in Orange Small Cap, para. 121

⁵⁴⁶ Opinion by AG Bot in Orange Small Cap, para. 144

⁵⁴⁷ Judgement by the ECJ in Orange Small Cap, para. 30 and 32

⁵⁴⁸ Judgement by the ECJ in Orange Small Cap, para. 34-36

⁵⁴⁹ Judgement by the ECJ in Orange Small Cap, para. 37 and 41

⁵⁵⁰ Judgement by the ECJ in Orange Small Cap, para. 42

⁵⁵¹ Judgement by the ECJ in Orange Small Cap, para. 47

although DTCs were limited in scope to the persons referred to, if the benefit concerned was separable from the convention and did not contribute to the overall balance of it, then Community law precluded national legislation that did not grant this benefit to a resident of another Member State insofar as the residents of the two states were in a comparable situation.⁵⁵² Thereafter, the Court held that the right to such a concession was not a result of an automatic application of a DTC but rather a result of a unilateral decision of the Netherlands to extend the benefit in such conventions to FIEs.⁵⁵³ The exclusion of the right to concession of dividends origination in certain Member States was thus found to constitute a restriction.⁵⁵⁴ However, the Court found later that the situations of companies in a Member State with which the Netherlands had concluded or had not concluded a DTC respectively was not comparable.⁵⁵⁵

The Court noticed that the concession was reduced in proportion to shares held by foreign shareholders and thus the national legislation drew a distinction between such shareholders and domestic shareholders.⁵⁵⁶ This kind of distinction in the national legislation created a restriction because it made it more favourable to attract shareholders from the same state of residence as the FIE than from other Member States.⁵⁵⁷ The Court rejected that domestic and foreign shareholders were not in a comparable situation, since the Netherlands had chosen to tax both sets of shareholders for dividends received from an FIE and thus, as soon as the Netherlands had chosen to do so, it was obliged to extend the benefit of a tax concession to FIEs with foreign shareholders.⁵⁵⁸ The Court also rejected an argument based on the fact that the reduction of the concession was based on the liability to tax in the Netherlands, since it thought that that objective was not to be achieved with the current provisions, since they lead to a reduction of the total amount of profit available for distribution and the reduction in concession had the effect of avoiding a reduction in tax revenue on the distributed dividends.⁵⁵⁹

5.3.3.8.3 Comments

The Court held that the Dutch legislation treated both inbound and domestic dividend payments received by an FIE the same, as such a company was not liable to tax on dividends received. The Court held however that the concession system applicable when an FIE received foreign sourced dividend payments constituted a restriction, as the application of the system was subject to conditions and was reduced in proportion to shares held by foreign shareholders. This should be compared to the refund of tax already paid that an FIE was entitled to when it received domestic sourced dividend payments. The refund of tax already paid and the concession had the same purpose, which was to make sure that an FIE wasn't liable to tax, except

⁵⁵² Judgement by the ECJ in *Orange Small Cap*, para. 50-51

⁵⁵³ Judgement by the ECJ in *Orange Small Cap*, para. 54

⁵⁵⁴ Judgement by the ECJ in *Orange Small Cap*, para. 56

⁵⁵⁵ Judgement by the ECJ in *Orange Small Cap*, para. 61-64

⁵⁵⁶ Judgement by the ECJ in *Orange Small Cap*, para. 70

⁵⁵⁷ Judgement by the ECJ in *Orange Small Cap*, para. 73-74

⁵⁵⁸ Judgement by the ECJ in *Orange Small Cap*, para. 78-79

⁵⁵⁹ Judgement by the ECJ in *Orange Small Cap*, para. 83-83

when the profit of such a company was distributed, which had to be done within 8 months after the end of the tax year. As the Netherlands had chosen to relieve the double taxation arising, it had to be done in compliance with Community law. The fact the granting of the concession was subject to conditions and reduced in proportion to shares held by foreign shareholder, whereas no such conditions applied to the tax refund, foreign investors might be deterred from investing in an FIE and the FIE from seeking investors in other Member States.

It has been suggested that this case has set aside the holding made by the Court in *Manninen*.⁵⁶⁰

⁵⁶⁰ Spaas (2009), p. 63

6 The OECD model convention on double taxation

6.1 Introduction

The main purpose of the OECD model convention on double taxation is to provide a measure to solve problems arising in an international context due to juridical double taxation.⁵⁶¹ Another is “...to clarify, standardize and confirm the fiscal situation of taxpayers...” when they engage in cross-border activities through the application of common solutions to cases of double taxation.⁵⁶² The model convention and related documents to it have had a significant impact on international tax law and the repercussions have been wide spread.⁵⁶³ It has especially made a significant impact in the field of tax treaty law, concerning the negotiations, application and interpretation of tax treaties, and today most of the tax treaties concluded is in conformity with the model convention.⁵⁶⁴ It can therefore be said to have contributed to a harmonization of the tax treaties concluded by Member States of the OECD.⁵⁶⁵

The model consists of about 30 articles, which can be divided into four categories: 1) Articles containing definitions 2) Distributive articles 3) a method article and 4) other articles. The commentary on each article provided by the OECD is also a useful tool when applying or interpreting the model convention.⁵⁶⁶

To fall within the scope of the model convention, it is necessary for the person to be considered to be a resident of a contracting state or of both.⁵⁶⁷ The term resident under the model convention includes “...any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature...”⁵⁶⁸. By the reference to the domestic law of the Member States, the definition covers almost all of the jurisdictional connection factors that give rise to full tax liability.⁵⁶⁹ However, the reference to the domestic law of the contracting states might result in that a person is considered to be a resident of both of the contracting states; articles 4.2 and 4.3 addresses that situation.⁵⁷⁰

Regarding the phrase “liable to tax” in article 4.1, it must be noticed that some states may regard a person to be liable to tax there even if the state

⁵⁶¹ OECD Model convention – Commentaries – Introduction, para. 3

⁵⁶² OECD Model convention – Commentaries – Introduction, para. 2; Hilling (2005), p. 54

⁵⁶³ OECD Model convention – Commentaries – Introduction, para. 12-15

⁵⁶⁴ Hilling (2005), p. 55

⁵⁶⁵ Ibid.

⁵⁶⁶ Ibid.

⁵⁶⁷ OECD model convention, article 1; Dahlberg (2007), p. 166

⁵⁶⁸ OECD model convention, article 4

⁵⁶⁹ Hilling (2005), p. 56

⁵⁷⁰ Ibid.

does not in fact impose tax.⁵⁷¹ If a state treats a partnership as fiscally transparent and thus imposes tax on the partners for their respective share in that partnership, the partnership may not be regarded as a resident of that state.⁵⁷²

After the provisions that lays down the scope and definitions needed for the application of the model convention, the provisions that follows lays down which of the contracting states that has the right to tax (or sometimes to both or the parties). These so-called distributive rules can either confer a primary (“may be taxed”) or exclusive (“shall be taxable only in”) right to tax to one of the contacting parties or the right to tax can be divided between the parties.⁵⁷³

Tax treaties between the Member States are in principle binding, but they will be overruled by EC law if they are incompatible with Community law; the Member States have to organize its tax treaties in compliance with Community law and may not rely on such a treaty for the justification of a denial of national treatment.⁵⁷⁴

6.2 Article 10 – Dividends

Article 10.1 confers the right to tax distributions of dividends to the state in which the recipient is resident. However, when the recipient is resident in another state than the state of the distributor, then the state in which the distributor of the dividends is resident may tax such distributions (article 10.2). Since the article does not contain a restriction as to when dividends may be taxed, taxation can occur even before the dividends are considered to have been paid.⁵⁷⁵ This right is however limited to 5 % of the gross amount of the dividends if the beneficial owner is a company and directly owns at least 25 % of the distributing company⁵⁷⁶ (article 10.2(a)) or, in all other cases, to 15 % of the gross amount (article 10.2(b)). Article 10 takes precedence over article 7 (business profit) if a corporation receives the dividends.⁵⁷⁷

The third paragraph of the article lays down the meaning of the term dividend within the model convention. The term is said to encompass income from shares, “jouissance “ shares and “jouissance” rights etc. These are mere examples of distributions that may fall under the term dividends. For all other types of income from corporate rights, the qualification made by the state of source will prevail (article 10.3); the concepts “income” and corporate rights” should be interpreted broadly.⁵⁷⁸ However, the article does not only apply to dividends as such. The concept is also applicable to interest that is regarded as dividends under national rules on thin capitalization.⁵⁷⁹ Other benefits in money or in moneys worth such as bonus shares,

⁵⁷¹ OECD Model convention – Commentaries – Article 4, para. 1, note 8.5

⁵⁷² OECD Model convention – Commentaries – Article 4, para. 1 note 8.7

⁵⁷³ Hilling (2005), pp. 57-58

⁵⁷⁴ Terra/Wattel (2008), p. 798

⁵⁷⁵ Vogel et al. (1997), p. 587 note 22 and p. 588 note 24

⁵⁷⁶ In the nominal capital, see Vogel et al. (1997), p. 600 note 77

⁵⁷⁷ Vogel et al. (1997), p. 584 note 9

⁵⁷⁸ Vogel et al. (1997), p. 649 note 186 and p. 650 note 189

⁵⁷⁹ OECD Model convention – Commentaries – Article 10, para. 3 note 25

profits on liquidation is also within the scope of the term dividends as long as the state in which the distributing company is a resident taxes such benefits as dividends; however, distributions that results in the reducing of the membership rights are not regarded as dividends.⁵⁸⁰ Paragraphs 4 and 5 concerns two different situations where a permanent establishment⁵⁸¹ is involved. Paragraph 4 states that if the recipient carries on a business through a permanent establishment in the same contracting party as the distributing company and the holding of which the dividend payment is linked to is effectively connected to that establishment, then article 7 shall apply. Paragraph 5 states that the first contracting party may not tax dividends derived in the second contracting party, even if the company is a resident of the first contracting party. However the first contracting party may make such a distribution liable to tax if it is made to a resident of the second contracting party or if the dividends stems from a holding effectively connected to a permanent establishment in the second state.

6.3 Article 23 A and B – Methods for elimination of double taxation

6.3.1 Introduction

The objective of the article is to eliminate international juridical double taxation in the State of residence, whereas the elimination of such double taxation in the State of source follows from the distributive articles.⁵⁸² The measures provided for in the distributive rules takes precedence over and are supplemented by article 23.⁵⁸³ Neither of the methods in article 23 is intended to be the one and only method, they are in fact supplemented by elements of the other method.

The philosophies behind the two methods vary considerably. The thought behind the exemption method is that it is the state in which an income arise or where the capital is situated that has the better right to tax, whereas the credit method is designed to mitigate the burden considered to be excessive or/and harmful by reducing the burden of tax.⁵⁸⁴ From an economic point of view, the exemption method provides for conditions that are equally competitive for investors from different states in the state of source, whereas the credit method provides equal treatment in the state of residence for investments made home and abroad.⁵⁸⁵

6.3.2 The exemption method

The exemption method is one of the methods that the model convention provides for the elimination of international double taxation in the state of

⁵⁸⁰ OECD Model convention – Commentaries – Article 10, para. 3 note 28

⁵⁸¹ OECD Model convention, article 5

⁵⁸² Vogel et al. (1997), p. 1130 note 36

⁵⁸³ Vogel et al. (1997), p. 1130 note 36a

⁵⁸⁴ Vogel et al. (1997), p. 1131 note 39

⁵⁸⁵ Vogel et al. (1997), pp. 1130-1131 note 40

residence. According to article 23 A (1), if a resident derives income from the other contracting party and that state may tax that income, then the state of residence shall exempt the income from tax. This means that the income shall be excluded from the taxable base.⁵⁸⁶ That will result in non-consideration of such income in the calculation of any carry-forward or carry-back of losses incurred in the home state.⁵⁸⁷ Thus, profits derived abroad can generally not be set off against domestic losses.⁵⁸⁸ Usually, it doesn't matter if the income is subject to any liability to tax in the other contracting state or if tax payable to that state has been paid or not.⁵⁸⁹

Article 23 A (2) proposes that the contracting state chooses to apply the credit method on dividends and interest. This is due to the fact that the distributive rules concerning dividends and interest provides for taxation by the source state up to a certain amount when dividends are distributed to a person in his state of residence.⁵⁹⁰

The third paragraph in article 23 A provides for the application of the exemption method with progression. This method allows the state of residence to take income derived from the other contracting state into account when that state is to determine the applicable income tax bracket.⁵⁹¹ The applicable tax bracket is thus based on a calculation that includes the foreign income, although that income is thereafter exempted from income tax.

The purpose of article 23 A (4) is to prevent double non-taxation due to the application of the exemption method.⁵⁹²

6.3.3 The credit method

The other method for the elimination of double taxation provided for by the model convention is the credit method (article 23 B).

Article 23 B (1) lays down the basic rule. If a person, resident in one of the contracting states, derives income from the other contracting party that that state may tax, then the state of residence shall allow that person to credit the tax already paid in the state of source against the income tax due in the state of residence.⁵⁹³ Thus, the residence state includes income that the state of source may tax when it computes the domestic tax due, but the state of residence then allows a credit for the tax paid in the state of source.⁵⁹⁴ The credit can be granted for either the full amount of foreign tax paid (full credit) or either it can be limited to the amount that would have been taxed if the income had been derived from the state of residence (ordinary credit), however often limited to income from that other state ("per country limitation").⁵⁹⁵ The credit method under the model convention is

⁵⁸⁶ Vogel et al. (1997), p. 1179 note 68

⁵⁸⁷ Vogel et al. (1997), p. 1180 note 68a

⁵⁸⁸ Hilling (2005), p. 62

⁵⁸⁹ Vogel et al. (1997), p. 1179 note 68

⁵⁹⁰ Dahlberg (2007), p. 193

⁵⁹¹ Vogel et al. (1997), p. 1260 note 207

⁵⁹² Dahlberg (2007), p. 193

⁵⁹³ Dahlberg (2007), p. 194

⁵⁹⁴ Hilling (2005), p. 63

⁵⁹⁵ Dahlberg (2007), p. 194; Vogel et al. (1997), p. 1230 note 167

only an ordinary credit.⁵⁹⁶ Losses incurred abroad can generally be used to set off domestic income, but where domestic losses are prevented to use to set off against positive income, that prevention applies in principle to foreign losses as well.⁵⁹⁷ There is however no details in the model convention concerning how the credit shall be computed, that is for the contracting parties to decide.⁵⁹⁸

Article 23 B (2) contains a provision that allows the state of residence to take the foreign tax paid into account when that state is computing the domestic income tax.⁵⁹⁹ The question of whether losses incurred abroad may be included and thus reduce the taxable base is a question to be answered by domestic law.⁶⁰⁰

6.4 Comments

The previous chapters in this thesis has dealt with theories and principles concerning double taxation, different taxation systems and about how to achieve neutrality in the international tax system, as well as describing the treatment of inbound and outbound dividend payments in EU, both as regards holdings to which the Parent-Subsidiary directive is applicable and holdings protected by the fundamental freedoms in the EC Treaty. This chapter has dealt with international tax law and to be more precise, the OECD model convention on double taxation. This chapter has provided a presentation of the allocation of taxation rights concerning dividend payments, a presentation of the meaning of the dividend concept under the model convention and the methods provided by the model convention on how to eliminate double taxation. This has been done in order to provide a presentation of how these issues are dealt with in a source of law that is internationally accepted and has been able to harmonize this particular area of tax law. It has also been done in order to be able to compare the treatment derived in the chapters on the Parent-Subsidiary directive and on the treatment of dividend payments in the light of the fundamental freedoms.

⁵⁹⁶ OECD Model convention – Commentaries – Article 23 B, notes 16 and 29

⁵⁹⁷ Vogel et al. (1997), p. 1231 note 170

⁵⁹⁸ Dahlberg (2007), p. 194

⁵⁹⁹ Ibid.

⁶⁰⁰ Vogel et al. (1997), p. 1263 note 214

7 Analysis

7.1 The treatment of dividend payments in EC law

7.1.1 General remarks

From 1 January 2009, the threshold for the application of the benefits contained within the Parent-Subsidiary directive has been lowered to a 10 % holding in the capital. This requirement has thus been lowered from 25 % to 10 % and the scope of the directive has been widened substantially since it was adopted. The amendments made in 2003 implemented more legal forms in the annex to the directive, again widening the scope. But even though the scope of the directive has been widened in the past few years, there will be holdings of shares that don't fulfil the requirements in the Parent-Subsidiary directive and they will thus not be able to benefit from the preferential treatment laid down by the directive. However, the rights conferred to them by the free movement provisions of the EC Treaty protect these holdings, held by either legal or natural persons. The case law produced by the ECJ, which has been presented above, has determined the level of protection that taxpayers enjoy under these provisions. Comments on the treatment of distributions of profit under the Parent-Subsidiary directive will be made in the two following chapters, together with remarks of a more specific nature, whereas this chapter will contain remarks of a more general nature.

When assessing a question in the light of the fundamental freedoms, the Court decides first which one of the freedoms that is applicable in the corresponding case, then the comparability of the situations, then if there exists any argument able to justify the concerned difference in treatment and last, if the measure in the national law is proportionate.⁶⁰¹ As regards the comparability issue, the ECJ has often held, in the cases referred to above, that a purely internal situation and a cross-border situation is comparable to each other, although not per se, if the concerned state has decided to exercise its taxing jurisdiction over the foreign national in a way which is to a high extent comparable to the treatment of the state's own nationals.⁶⁰² In principle and in practise, this seems to be a good way of approaching things. If two taxpayers are subject to tax in a state in a comparable way, then they should enjoy the same tax benefits. In theory, however, that might be different. The rationale behind the liability to tax at residence and at source is fundamentally different. The connecting factors, residence and source, are not equally strong and the application of the two principles thus not give rise to the same liability to tax. Connection by residence usually gives rise to unlimited liability to tax, whereas connection by source only results in a limited liability to tax. It has also been recognized that a state acting in a

⁶⁰¹ Lang (2008), p. 67

⁶⁰² E.g. in *Amurta*, *Aberdeen*, *Denkavit*, *FII Test Claimants* and *Orange Small Cap*

home state capacity cannot be said to have the same obligations as when the state is acting in a source state capacity.⁶⁰³ One may therefore question if, in theory, the situations really is comparable to each other, since the taxation of the resident and the non-resident is based on two different principles. However, this reasoning is hard to apply if one seeks to establish an Internal Market. In such a market, allocation of profit and the establishment of corporations will be ineffective if residents and non-residents, which are subject to tax in a way that is highly comparable to each other, does not enjoy the same preferential treatment due to were they are residents or are established. Individuals and corporations will be deterred from establishing themselves in the relevant state or in another Member State. However, the obligations of the states must be differentiated based on if the state is acting in a home or a source state capacity.⁶⁰⁴

Another fact is that the case law of the ECJ has in principle removed the attractiveness of the imputation system when it has demanded that the state applying such a system grants the individual shareholder a credit for the corporation tax paid in another Member State or allow a similar exclusion for inbound dividend payments from another Member State. This has been welcomed by some commentators due to the practical issues with such a system, whereas other has advanced the opinion that this might have lead to a widening in tax treatment of debt and equity between the Member States, which they think is not necessarily good for the EU.⁶⁰⁵

7.1.2 Inbound dividends

In order to avoid that economic double taxation arises on inbound dividend payments that has already borne tax in another Member State, the Parent-Subsidiary directive prescribes that the Member State in which the recipient of the dividend payment should either exempt the dividend from tax or grant the shareholder a credit for the foreign tax paid in respect of those dividends. This article has been held by the ECJ to have direct effect. This means that citizens of the Member States may rely on this provision before their national courts. The result of this may be that the Member States will be put under an increased pressure to ensure that their national legislation concerning this matter is in conformity with the directive in this part and the relevant case law of the ECJ. Disregarding this increased pressure, the weight of the provision will increase dramatically since it is now not only addressed to the Member States, but also directly to the citizens of the Member States. This will in my point of view, result in a better and faster harmonization and approximation of the laws of the Member States in this area. But, maybe more importantly, the direct effect of this provision will increase the incentives and the opportunities for corporations in the different Member States to group themselves together, because now they may rely on the provisions of the directive before their national courts in order to both distribute and receive dividends without being subject to double taxation.

⁶⁰³ AG Geelhoed in ACT Test Claimants, pp. 33-34; for an opposing view, see Graetz/Warren (2007), pp. 1612-1613 and Vanistendael (2008), p. 61

⁶⁰⁴ Ibid.

⁶⁰⁵ Terra/Wattel (2008), pp. 180-181, 189 and 810; Graetz/Warren (2007), p. 1603

The corporations may thus rely on the directive when they are seeking to exercise their rights due to EC law. This will lead to a better functioning of the Internal Market, which is one of the main objectives with the EU.

However, it must be remembered at this point that the Member State may choose either one of the methods prescribed for in the directive and the Member States may even apply one method for domestic dividend payments and the other method for foreign dividend payments. Still, the Member States have to comply with the free movement provisions in the EC Treaty.⁶⁰⁶ To determine if the tax burden is equal in such a situation, the cumulative tax burden of the parent and subsidiary has to be examined.⁶⁰⁷

So, even if the Member States may choose how to implement the provisions of the directive into its domestic law, the rights of the corporations has been reinforced by the fact that article 4(1) of the directive has been held to have direct effect and they may even rely on the free movement provisions in the EC Treaty as a last instance.

The issue most likely to arise in cases of inbound dividend payments is that the recipient of the foreign sourced dividend doesn't receive the same preferential treatment as when dividends are distributed domestically. It may be that a special scheme resulting in relief from or elimination of double taxation isn't applicable or that an imputation credit is not granted for underlying corporate tax due in another Member State.⁶⁰⁸ When this kind of tax benefits are denied when the dividend income is received from another Member State, the proper functioning of the Internal Market is undermined. The residents of the state will think twice before they make an investment in another Member State and foreign corporations will be deterred from seeking investments from that state. And although tax issues are not the only relevant criteria when you establish your corporation in another state or when you invest in another state, it can be of great significance. Thus, in order to fulfil the aim of an Internal Market, the fundamental freedoms concerning establishment and movement of capital has to be attained and obstacles existing have to be removed.

In the case law concerning inbound dividend payments as described above, the Court has consistently held that that when the Member State have made inbound payments subject to tax in a way which makes them comparable to when dividend payments are made in a domestic context, it has to extend the benefits granted to these inbound dividend payments.⁶⁰⁹ No action is however required from the Member State when it treats domestic and foreign sourced dividends in the same manner.⁶¹⁰ The Member States are also at liberty to choose how to deal with international double taxation. They may apply either the exemption or the credit method, as under the Parent-Subsidiary directive, and they may even apply them simultaneously.⁶¹¹

⁶⁰⁶ FII Test Claimants; Kofler, p. 15

⁶⁰⁷ Kofler, p. 15

⁶⁰⁸ See e.g. Verkooijen and Manninen; Denys (2007), pp. 223 and 226-227; Terra/Wattel (2008), p. 829

⁶⁰⁹ See e.g. Lenz and Manninen

⁶¹⁰ See the judgement by the ECJ in Kerckhaert Morres

⁶¹¹ FII Test Claimants

However, this has to be done in compliance with the fundamental freedoms.⁶¹²

The reasoning above may give the impression of a consistent case law, but one has to have a closer look before that can be held to be the case. First I would like to discuss the argument that has been used by the Court when, e.g. in *Kerckhaert Morres*, it held that there were no restriction because the issue in the case were due to the exercise in parallel by two Member States of their fiscal sovereignty. However, this is the issue in all of the cases referred to above. This is why issues concerning international juridical and economical double taxation arise. When dividends are distributed cross-border, two states are involved and they are exercising their fiscal sovereignty in a way that creates double taxation.⁶¹³

Another important aspect is that the taxation systems of the Member States are designed differently and when assessing them, they must be seen as a whole. Benefits and disadvantages are often intrinsically linked, e.g. a disadvantage in one system compared to another might be cancelled out by a benefit in another area in the taxation system. In this context, it is interesting to assess the argument put forward by the Court in a number of cases that the discrimination created by the domestic legislation is not undone by another advantage/s.⁶¹⁴ One might wonder why these so-called other advantages are of no interest when the Court is assessing the nature of the domestic legislation to see if the legislation is discriminative.⁶¹⁵ In order to get a complete and correct view of the situation, one must assess the whole chain of events involved in the distribution, not only at the distributor or the recipient of the dividend. However, the ECJ has not always taken this approach. In *Saint-Gobain*, the Court did not consider the whole chain of events that was a part of the distribution.⁶¹⁶ In the cases of *Verkooijen* and *Lenz* the Court did not recognize the link between the shareholder and corporate taxes, whereas it did so in *Manninen* and *Meilicke*.⁶¹⁷ It has also been argued that the holding that the payment of ACT was a prepayment of corporation tax in *Metallgesellschaft*, which was referred to in both *ACT Test Claimants* and the *FII Test Claimants*, failed to recognize the relationship between the corporation and the shareholder tax.⁶¹⁸

Some commentators are claiming that the Court has had problems dealing with the UK system of ACT and in particular the distinguishing between corporation tax and withholding tax within such a system. This has resulted in a possibility for the Member States to achieve the same result by applying a different measure and thus avoid the striking down of the national provision.⁶¹⁹ The possibility granted to the Member States in the *FII Test Claimants* case to apply either one of the exemption or the credit method to relieve double taxation for domestic sourced dividends and the other method for foreign sourced dividends has also been criticised. The

⁶¹² *Ibid.*

⁶¹³ Graetz/Warren (2007), p. 1596

⁶¹⁴ In e.g. *St Gobain, Verkooijen and Lenz*

⁶¹⁵ Graetz/Warren (2007), p. 1594

⁶¹⁶ *Ibid.*

⁶¹⁷ Graetz/Warren (2007), p. 1597

⁶¹⁸ Graetz/Warren (2007), p. 1605

⁶¹⁹ Lang (2008), p. 72; Graetz/Warren (2007), p. 1620

arguments advanced are based on the fact that the system that applied in the case in respect of foreign source dividends created an excess burden for companies receiving such dividends both substantially and administratively and it has also been suggested that the holding made by the Court in the FII Test Claimants case was contrary to the holding made in the Cadbury Schweppes case.⁶²⁰

The judgement by the Court in the Kerckhaert Morres case has been subject of some criticism. As been mentioned above, the ECJ has been criticized for holding that no violation had occurred in that case since the additional burden for inbound dividends was due to the exercise in parallel by two states of their fiscal sovereignty. That critique is based on the reasoning that all the issues that is discussed in the cases mentioned in respect of this subject has risen due to the interaction between two sovereign states.⁶²¹ Questions has also been asked about the fact that it seems like a state might have different obligations depending on in which capacity it is acting and if the Court is willing to treat imputation and withholding tax as functional equivalents.⁶²² The Kerckhaert Morres case has also been criticized for handing the Member States the opportunity to redesign their tax system in order to comply with the EC Treaty but achieving the same economic effects as before; however, the same writers are of the opinion that the holding by the ECJ is correct in principle since "...a disparity is not discrimination..." and an issue created by two Member States should not be blamed on only one of them.⁶²³

Then there is the relatively new case, Orange European Small Cap. In this case the ECJ held that the national legislation didn't give rise to any discrimination, since both inbound and domestic dividend payments were subject to taxation at 0 %. However, the legislation was held to constitute discrimination insofar as it made a concession, applied to reduce the double taxation arising when receiving inbound dividend payments, subject to conditions and limited it in relation to the foreign interest in the company. First of all it must be noticed that the Court, when arguing that there were no discrimination of inbound dividend payments, regarded the whole chain of events connected to the distribution and found that the disadvantage that had risen was due to the imposition of tax in the state of source and the state of residence could thus not be held to have created a restriction.⁶²⁴ A thought has been advanced that the holdings in Manninen has been cast aside by this judgement, although a reservation based on the fact that Manninen concerned economic double taxation, whereas this case didn't, was made.⁶²⁵ If one compares the facts of the cases, then one sees a difference. In Manninen, no imputation credit was granted for the tax paid in another Member State and thus economic double taxation occurred when the shareholder became liable to tax in Finland. In Orange however, both inbound and domestic dividends received by an FIE were subject to corporation tax

⁶²⁰ Terra/Wattel (2008), pp. 830-832

⁶²¹ Graetz/Warren (2007), p. 1612

⁶²² Graetz/Warren (2007), pp. 1612-1613; see chapter 3.1, p. 16

⁶²³ Terra/Wattel (2008), pp. 812-813

⁶²⁴ Orange European Small Cap, p. 58

⁶²⁵ Spaas (2009), p. 63

at 0 %, thus no discrimination. If one compares the function of the imputation credit with the refund/concession system, then one notices that the function is the same, to take tax already paid into account. In Manninen, the credit was granted to the shareholder and in Orange, the refund/concession was granted to the corporation, but the function remains the same. In both cases, the ECJ came to the conclusion that by not granting the same credit/refund/concession to inbound dividends as compared to domestic dividends, the legislation of the states had created a restriction. Thus the ECJ struck down a mechanism in both cases with the same function, but placed differently within the chain of events. The fact that the ECJ found no discrimination when the Netherlands subjected both inbound and domestic dividends to tax at 0 % can, when comparing that to the judgement in Manninen, not be surprising because there were no economical double taxation in the Orange case and after all, different cases shall be treated differently, also by the ECJ.

7.1.3 Outbound dividends

According to the Parent-Subsidiary directive, the Member States are not allowed to impose a withholding tax on outbound dividend payments. This is done in order to remove an obstacle for companies when they are seeking to establish themselves in another Member State. The obstacle consists in that the state of source wants to tax the income distributed cross-border based on the source principle. However, since in general no such taxation occurs when a distribution of profits is made within the state, then corporations are deterred from establishing themselves in another Member State.

This article has been held by the ECJ to have direct effect. The results that this might lead to are of the same character as described just above concerning the provision in the directive concerning inbound dividend payments. The pressure on the Member States to amend their legislation will be increased and the grouping together of companies within the Internal Market is likely to increase. It must also be stressed that it is of great importance that both the provision concerning inbound dividend payments and the provision concerning outbound dividend payments has been held to have direct effect. Within a group of companies, these payments are two sides of the same coin. Both sides of the coin have to be addressed in order to relieve the company group from double taxation. Both the risk that the distribution of profit may be subject to a withholding tax when the distribution is made cross-border and that the receiving company wouldn't be able to get relief for the underlying corporation tax will deter companies from making a secondary establishment in another Member State and from grouping themselves together with companies from other Member States. But since both the provision regarding inbound dividend payments and the provision regarding outbound dividends has been held to have direct effect and the fact that the free movement provisions provides a safety net as regards the implementation of article 4(1), it must be considered that the corporations have been given a level playing field in this area of direct taxation, which is essential for the proper functioning of the Internal Market.

From the case law referred to above, one may conclude that a difference in treatment for outbound dividend payments as compared to domestic dividend payments is not permitted. This view has been expressed by the ECJ in a number of variations. Resident branches of a foreign company must be able to enjoy the same benefits as domestic branches, foreign taxpayers may be treated differently but that must not lead to a unfavourable tax treatment as compared to resident taxpayers and foreign residents may not be liable to a tax that doesn't exist for resident taxpayers.⁶²⁶ We can also see that a Member State is not required to relieve double taxation for a foreign resident as long as it has not made that resident liable to tax, but were it has done so, it must extend e.g. an imputation credit to the foreign resident insofar as it is in a comparable situation to a resident.⁶²⁷ However, if the state in which the shareholder is a resident prevents economic double taxation for domestic dividend payments, then it must extend that treatment to inbound dividend payment, meaning the granting of a credit for foreign corporation tax paid.⁶²⁸ If the legislation in the state of source gives rise to a restriction, then that measure has to be neutralized by the state of source.⁶²⁹ Otherwise, the state of source has to ensure that the state of residence does it.⁶³⁰ The Member States are thus permitted to treat domestic dividend payments and outbound dividend payments differently, as long as the treatment of the respective payments is not comparable to each other. However, as soon as the state of source decides to exercise its taxing jurisdiction in respect of outbound dividend payments, then those kinds of payments becomes comparable and they may not suffer a higher liability to tax then domestic dividend payments, but they may be treated differently.

However, the cases concerning outbound dividend payments have also been subject to criticism. The fact that the withholding tax regime applied by France in the *Denkavit* case was held to constitute a restriction and no the imputation system applied by the UK in *ACT Test Claimants* has been criticized. It is important to note at the outset that *Denkavit* concerned a withholding tax whereas *ACT Test Claimants* concerned the imputation system applied by the UK at the time. The fact that the ECJ distinguishes the cases based on this point has been argued to prove that the ECJ has misunderstood the relationship between a withholding tax and imputation.⁶³¹ However, the distinction between the two cases has been defended on the ground that the French withholding tax was final whereas the ACT was a payment of corporation tax upon distribution of dividends and because a UK and a foreign recipient were not in a comparable situation.⁶³² Examples have however shown that adopting different designs of the taxation systems can attain the same economic effects in principle, but some could be struck down by the ECJ on the grounds in either *Denkavit* or *ACT Test Claimants*

⁶²⁶ See *Avoir fiscal*, Bouanich and *Denkavit/Amurta* respectively; Terra/Wattel (2008), p. 827

⁶²⁷ See *ACT Test Claimants*; Terra/Wattel (2008), p. 828

⁶²⁸ Terra/Wattel (2008), p. 828

⁶²⁹ Lang (2008), p. 71

⁶³⁰ *Ibid.*

⁶³¹ Graetz/Warren (2007), p. 1615; see chapter 3.1, p. 16

⁶³² Vanistendael (2007), p. 212

or permitted by one of the cases.⁶³³ This is regrettable, since it gives the Member State an opportunity to design their taxation system in a different manner but resulting in the same economic effect in order to avoid its legislation to be struck down by the ECJ. It also hinders the proper functioning of the Internal Market, because two different taxation systems giving rise to the same economic effect/s and maybe the same restriction/s are treated differently by the ECJ and thus some restrictions will be dealt with, others will be left to exist.

It is also worth considering the judgement by the EFTA Court in the Fokus Bank case. In that case, the Court held that the Norwegian legislation gave rise to a restriction of the free movement of capital when it prescribed that the imputation credit granted to residents were not granted in full to non-residents on payments of dividends originating in Norway. It has been argued that the holding by the EFTA Court is in compliance with the holding made by the ECJ in ACT Test Claimants.⁶³⁴ The two Courts seem to have adopted different views on whether a difference in treatment in the state of source could be neutralized by an advantage provided for by a DTC or the national legislation of the state of residence of the recipient of the dividend.⁶³⁵

The same arguments as advanced in connection with the Kerckhaert Morres case has been advanced in respect of the Amurta case, that the Member States may avoid the scrutiny under the EC Treaty and attain the same economic effects as before by redesigning its taxation system; in the Amurta case, that would be possible if the Netherlands withdrew its exemption for domestic dividend payments.⁶³⁶

The question has risen whether the EC Treaty precludes a withholding tax as such on dividend payments.⁶³⁷ It is of interest in the Netherlands since the withholding tax levied there is creditable against the income tax due for corporate and individual domestic shareholders, which results in the effect that almost all of the withholding tax is collected from non-resident shareholders.⁶³⁸ However, I am of the opinion that a withholding tax cannot be considered to be prohibited per se by the EC Treaty. The discriminatory nature of a withholding tax must be determined on a case-by-case basis. And, based on the legal reasoning of the ECJ, only a difference in treatment of situations that are objectively comparable can be held to create a restriction. If the state of source decides to exercise its taxing jurisdiction in respect of outbound dividend payments in a way that makes them comparable to domestic dividend payments, then outbound dividend payments may not be subject to an unfavourable tax treatment as compared to domestic dividend payments.⁶³⁹ However, if a similar withholding tax is levied upon distribution of both domestic and outbound dividend payments,

⁶³³ Graetz/Warren (2007), pp. 1615-1616; Lang (2008), p. 72

⁶³⁴ Terra/Wattel (2008), p. 188

⁶³⁵ Bullen (2007), p. 273; Graetz/Warren (2007), p. 1600; Terra/Wattel (2008), p. 188, footnote 104

⁶³⁶ Terra/Wattel (2008), pp. 828-829; compare to Bellingwout (2008), pp. 131-132

⁶³⁷ Bellingwout (2008), p. 131

⁶³⁸ Bellingwout (2008), pp. 131-132

⁶³⁹ Compare to the reasoning by the Court in Bouanich

then this cannot be held to constitute a restriction.⁶⁴⁰ Under the current legal reasoning adopted by the ECJ, a withholding tax as such thus cannot be regarded as precluded by the EC Treaty. It has however been advocated that, although the Member States are allowed to tax outbound dividend payments more heavily than domestic dividend payments if the state of residence eliminates the double taxation in accordance with a provision in the relevant DTC, it is in practice hard to determine the tax treatment in the state of residence and it is thus not practical for the Member States to tax outbound dividends more heavily than domestic dividends.⁶⁴¹

Then there is the Aberdeen case. The AG held in that case that the Finnish legislation created a restriction since outbound dividend payments were subject to a withholding tax upon distribution, unless they qualified for the preferential treatment prescribed by the Parent-Subsidiary directive or if an applicable DTC prescribed otherwise, whereas domestic dividend payments were not. The reasoning by the AG seems to be in line with the reasoning applied by the ECJ in the *Denkavit* and *Amurta* cases, however an interesting aspect is the legal character of the receiving company. The recipient was, after a creation of a company group, a Luxembourgian SICAV company, which is an investment company with variable capital and those are not subject to Luxembourgian corporate income tax.⁶⁴² The question that arises is if such a company, which was exempt from tax under its domestic legislation, is in a comparable situation to Finnish corporations liable to tax in Finland? When the ECJ assess the comparability issue, it asks itself what the purpose of the national legislation is.⁶⁴³ According to the Finnish government, the purpose of the national legislation was to avoid multiple taxation; the exemption from withholding tax was applicable for all legal persons with residence in Finland.⁶⁴⁴ Since the exemption applied generally, then, in my mind, there could not be any doubt that the SICAV company was in a comparable situation to Finnish companies. This is also supported by the fact that it has been held on two different occasions that SICAV companies are to be seen as entities resident in Luxemburg that are entitled to benefits provided for by the DTC between Finland and Luxemburg.⁶⁴⁵ However, it will be interesting to see the Courts view on this issue and also how they would assess the issue if the national legislation limited the exemption from withholding tax to certain legal persons.⁶⁴⁶

⁶⁴⁰ Terra/Wattel (2008), pp. 827-828

⁶⁴¹ Helminen (2008), p. 357

⁶⁴² Molander/Wijk (2009), p. 218; Helminen (2008), p. 357

⁶⁴³ See inter alia *Amurta*, para. 33, Opinion by AG Mazák in *Aberdeen*, para. 38 and Molander/Wijk (2009), p. 218

⁶⁴⁴ Opinion by AG Mazák in *Aberdeen*, para. 39

⁶⁴⁵ Helminen (2008), p. 357

⁶⁴⁶ Molander/Wijk (2009), p. 219

7.2 EC Law compared to the OECD Model

7.2.1 Introduction

At the outset, one must notice the purpose behind the different rules in the model convention. As described above in this thesis, there are different kinds of rules in the model convention. There are so called distributive rules and there are a method article. The purpose of the distributive rules are to allocate the right to tax between the two contracting parties, whereas the purpose behind the method article is to provide two different methods to solve international juridical double taxation.

This has to be compared to the purpose of the provisions in the Parent-Subsidiary directive. First we have the provision that provides that the state in which a parent company receiving a dividend is resident should either exempt that dividend from tax or allow the parent company a credit for the underlying corporate in respect of that dividend. The purpose behind this provision is to eliminate the possibility of economical double taxation, resulting from the taxation of the dividend first in the hand of the distributor and second in the hand of the recipient. The provision that prohibits the levying of a withholding tax when profits are distributed can also be said to have the same purpose. As we thus can see, there are no provisions in the directive concerning the allocation of the right to tax and the provisions concerning the elimination of double taxation does not target the same kind of double taxation as the model convention. However, a short comparison regarding the methods concerning the elimination of double taxation and the dividend concept will be made.

The double taxation situations in the case law from the ECJ often concerns economic double taxation, meaning that the same income is taxed twice in the hands of two different taxpayers. There is thus a difference between the model convention and the case law shaped by the ECJ, as the two different sets of rules are aiming at the elimination of different kinds of international double taxation. Also worth considering at this point is the fact that the ECJ has repeatedly held that the Member States are at liberty to determine the connecting factors by which they allocate their taxing powers among each other.⁶⁴⁷ As long as the Member States comply with EC law when they exercise this right, the Court will not interfere with the allocation of taxing powers. The Court has even held that the Member States are at liberty to choose anyone of the exemption and the credit method in order to relieve double taxation, they may even apply one in respect of residents and the other in respect of non-residents, as long as, if the situations can be said to be comparable to each other, non-residents are not subject to a higher tax than residents.⁶⁴⁸ The Court has also held that it will assess the effect of a relevant DTC in the cases before the Court if it is presented before the Court

⁶⁴⁷ See inter alia Bouanich, ACT Test Claimants and Denkvit Internationaal BV

⁶⁴⁸ See ACT Test Claimants

as a part of the legal context in which the national court is to decide the case.⁶⁴⁹

To conclude, the Member States may allocate its taxation power and eliminate double taxation in any way they seem appropriate, as long as the fundamental freedoms in the EC Treaty is not violated.

7.2.2 The Parent-Subsidiary directive

As seen above, both the Parent-Subsidiary directive and the model convention contains the same methods for the Member States/contracting parties to choose from when they seek to eliminate or provide relief from double taxation, although the kind of double taxation that they seek to relieve is different. The Member States of the EU have to comply with the fundamental freedoms provided for by the EC Treaty when they are exercising their right to choose the method to relieve double taxation. As concerns the credit method, both the model convention and the directive refers to the ordinary credit version of the credit method, meaning that a credit will only be granted for foreign tax already paid up to the amount of tax due if the income would have been taxed by the state of residence. The directive does not contain any specific provisions on the design of the two different methods, but it prescribes, from 2003, that a multi-tier credit has to be granted. There are more provisions in the model convention concerning the design of the different methods, but there are also here freedom to some extent for the contracting parties to design the methods in a way which the see fit.

Another interesting aspect/difference between the two sets of rules is the determination of the dividend concept. As seen above, the directive uses the term “distribution of profit”, whereas the model convention uses the term “dividend”. One of the weaknesses contained within the directive is that it does not provide a definition of the term “distribution of profit”. The concept is international tax law understood to have a broader meaning than the term “dividend”. The concept of distributions of profit must, in order to fulfil the aim of the directive, be given a broad scope and it is then likely to encompass most actual or fictive dividend equal payments.

7.2.3 The Case law

As held above, the Member States may choose to allocate their taxing powers among each other as they see fit and they also remain at liberty to choose how to eliminate double taxation, as long as they comply with Community law. The protection given to taxpayers by the fundamental freedoms as interpreted by the ECJ in its case law is not only available if the Parent-Subsidiary directive is not applicable, but also if it is. The treatment provided for in the directive must be given to qualifying corporations in compliance with the fundamental freedoms. As seen above, the Member State has to extend tax benefits granted to residents to non-residents when they are in a comparable situation. This is the case if the Member State has decide to ex-

⁶⁴⁹ See inter alia Bouanich, Denkvit Internationaal BV and Amurta; Terra/Wattel (2008), pp. 772-773

ercise its right to tax in respect of non-residents in a way which makes non-residents comparable to residents.

The case law shaped by the ECJ does not deal with the question of how the Member States allocate their right to tax. They may choose to allocate their right to tax in any way they want and one way of doing it is to use the distributive rules contained within the model convention. This is, in my view, the correct handling of the issue. There is no possibility that a restriction against a fundamental freedom can be created just by the allocation of the right to tax, since the connecting factors used to allocate this right is in principle neutral. The issues arise when the Member States are applying these connecting factors, since they often are applied in a discriminatory manner. The ECJ has frequently held that the Member States must treat comparable situations in the same way; they cannot apply these connecting factors in a discriminatory manner. The Member States must comply with Community law when they seek to relieve international double taxation, e.g. by the application of the exemption or the credit method in the model convention.

As said above, the Member States have to comply with the fundamental freedoms when they are seeking to relieve international double taxation. From this it is clear that the fundamental freedoms have an implication on the design and application of the credit and exemption method in the model convention.

The credit method allows the state of residence to make its residents liable to tax on the foreign income on the difference between the tax rate in the state of residence and the tax rate in the state of source, if the tax rate on the foreign income is lower in the state of source than in the state of residence. The effect of this is that any benefit of investing in another state is undone by the credit method and it also prevents residents of the credit state to compete in the state of source under equal conditions as the residents of that state.⁶⁵⁰ However, it has also been argued that the problem isn't the credit method, but rather the worldwide taxation by the state of residence and since the Member States are free to allocate their taxing powers, this might be hard to address.⁶⁵¹ Further issues could arise when the foreign tax is higher than the state of residence's or if a loss is incurred in the state of residence, when foreign tax credits are not able to be carried forward, if the credit method is subject to a per-country limitation or if the state of residence fully credits domestic withholding taxes, but subjects the credit of foreign withholding taxes to a limitation.⁶⁵²

There are also few issues regarding the compatibility of the exemption method with the fundamental freedoms. If the state has chosen to apply the exemption with a provision that safeguards progression, i.e. the foreign tax may be taken into consideration when the state of residence computes the tax liability of its residents, questions might arise about its compatibility since the resident will be subject to a higher tax if he invests abroad than if he would have invested domestically.⁶⁵³ That is not however the case, since

⁶⁵⁰ Loukota in Lang et al. (eds.) (2007), p. 137

⁶⁵¹ Loukota in Lang et al. (eds.) (2007), pp. 137-138

⁶⁵² Loukota in Lang et al. (eds.) (2007), pp. 140-146

⁶⁵³ Schilcher in Lang et al. (eds.) (2007), p. 156

a provision safeguarding progression leads to the same tax rate being applied on foreign investments as compared to domestic investments.⁶⁵⁴ The Member States are on the contrary free to apply such a provision as long as they apply the provision symmetrically and allows negative foreign income to reduce the domestic tax burden.⁶⁵⁵ Issues could arise concerning the treatment of exempted losses, deviations from the exemption method seeking to avoid double non-taxation and when the Member States makes the exemption method subject to different limitations in respect of different contracting parties.⁶⁵⁶

7.3 Adhering to CIN or CEN?

The theories of CIN and CEN have been presented above as the two main theories dealing with the issue of how to achieve neutrality in international taxation. Each of the theories can be said to be connected to a method that aspires to eliminate international double taxation, the exemption and the credit method. The CIN theory is connected to the exemption method, as that method provides equal competition in the state of source for investors originating from different states.⁶⁵⁷ The CEN theory is connected to the credit method, as that method provides equal treatment in the state of residence by taxing foreign and domestic investments in the same manner.⁶⁵⁸

As seen above, the Parent-Subsidiary directive gives the Member State the option to choose between the exemption and the credit method. The directive is thus adhering to both of the theories presented in this thesis. However, the Member States must comply with EC law when they are exercising this option. As regards the fact that the directive has not given precedence to any of the methods, professor emeritus Frans Vanistendael has advocated that the legislator should, when further amendments of the directive is considered, choose one of the methods and preferably the exemption method, as this method is in line with the basic principles of the Internal Market.⁶⁵⁹

As concerns the case law of the ECJ, it has been argued that this case law is inconsistent and one of the reasons behind this fact is the fact that the Court has tried to adhere to both of these theories.⁶⁶⁰ However, the ECJ has not given precedence to any of the methods in its case law.⁶⁶¹ The Member States may choose any of the methods to relieve double taxation. The Court has even held that the Member States may choose to apply one of the methods when relieving double taxation for residents and the other for non-residents, as long as, when non-residents can be said to be in a comparable situation to residents, non-residents are in practice not subject to a higher

⁶⁵⁴ Ibid.

⁶⁵⁵ Schilcher in Lang et al. (eds.) (2007), p. 159

⁶⁵⁶ Schilcher in Lang et al. (eds.) (2007), pp. 160-190

⁶⁵⁷ Schilcher in Lang et al. (eds.) (2007), p. 154

⁶⁵⁸ Ibid.

⁶⁵⁹ Vanistendael (2008), p. 60

⁶⁶⁰ Graetz/Warren (2007), pp. 1621-1622

⁶⁶¹ Terra/Wattel (2008), p. 779

taxation then residents.⁶⁶² The application may however be affected and influenced by Community law, as has been presented above.

In ACT Test Claimants, the ECJ held that the state of source could not be obliged to surrender its right to tax income derived from its territory. From this statement it can be derived that the Court may have given precedence to state of source taxation, so called source state entitlement.⁶⁶³ This means that the state of source has a right to either the corporation tax if the shareholder is a non-resident or “...the income tax on the dividend after imputation if the shareholder is a resident”.⁶⁶⁴ The state of source has however an obligation to extend the relieving of economic double taxation to inbound dividend payments if it has chosen to do so for domestic dividend payments.⁶⁶⁵ The arguments advanced by the Court to support this conclusion, that the state of residence is in a better position to assess the taxpayer’s overall ability to pay and the reliance on the Parent-Subsidiary directive, is rejected by Graetz and Warren.⁶⁶⁶ They suspects that the ECJ might have been influenced by the views of AG Geelhoed, which advocated source state entitlement based on international tax law, but Graetz and Warren accept neither this argument.⁶⁶⁷ The writers implies that that the ECJ has re-affirmed its holding in ACT Test Claimants with its holding in the FII Test Claimants and suggests that capital export neutrality has been preferred to capital import neutrality.⁶⁶⁸ There is however uncertainty as to where the Court stands, as it held in Bouanich that the state of source was required to extend its preferential treatment also to non-residents.⁶⁶⁹

Professor emeritus Frans Vanistendael argues that the theory of CIN is to be preferred to the theory of CEN, as that theory best serves the purpose of the Internal Market and is preferred by the Member States.⁶⁷⁰ Terra and Wattel also advocates source state entitlement and have a preference for the exemption method ahead of the credit method.⁶⁷¹

⁶⁶² See ACT Test Claimants

⁶⁶³ Terra/Wattel (2008), pp. 811 and 828; Graetz/Warren (2007), pp. 1606-1607; Lang (2008), p. 73

⁶⁶⁴ Terra/Wattel (2008), p. 828

⁶⁶⁵ Ibid.

⁶⁶⁶ Graetz/Warren (2007), p. 1607

⁶⁶⁷ Graetz/Warren (2007), p. 1608

⁶⁶⁸ Graetz/Warren (2007), p. 1611

⁶⁶⁹ Ibid.

⁶⁷⁰ Vanistendael (2008), p. 63

⁶⁷¹ Terra/Wattel (2008), pp. 171-172 and 179-180

8 Conclusions

8.1 The Parent-Subsidiary directive

In the area of positive harmonization, the Parent-Subsidiary directive has had an important role as regards the removal of double taxation on portfolio holdings. The Member States are obliged under the directive to eliminate double taxation on both inbound and outbound dividend payments if they are made within a context that qualifies for the preferential treatment laid down in the directive. As regards the conditions for the application of the preferential treatment in the directive, one can only applaud the fact that the scope has gradually been widened, by reducing the shareholder condition from a 25 to 10 % holding in the capital. One issue is however the technique used to determine the scope of the directive and in particular the fact that the legislator has chosen to list qualifying entities and taxes in an annex to the directive. This makes the directive less effective than it could have been if another technique had been used, e.g. to refer to the domestic company and corporation income tax law of the Member. If such a technique had been used, then you will not have not amend the directive every time there is a need to include more legal forms or taxes to the scope of the directive. Another issue is the fact the company must have its tax residence within one Member State according to the domestic law of that state. This might cause some problems, since different states may define this concept differently and it would be welcomed if the legislator could provide a better connecting factor than residence; one solution would be to apply the residence principle but, instead of linking it with one of the Member States, to link with the territory of the Community.

Another issue is the fact that the Community legislator wasn't able to prescribe only one method to eliminate double taxation on portfolio holdings within the Community. The Member States thus has the option to choose between the exemption and the credit method. Even though this option must be exercised in compliance with Community law, the fact that the Member States hasn't agreed on one method creates a difference in the way that the Member States treats inbound dividend payments. It would have been better if the Member States could have agreed on one of the methods, since that would have created a harmonization of the legislation of the Member States concerning the relief of double taxation. This is because the two different methods are based on two different lines of thought; as presented above, they adhere to two different neutrality theories (CIN and CEN). By providing the Member States with the option to choose which method to apply, the directive adheres to both principles. However, the best thing to do would be to agree on which one of these methods that best preserves the interest of the Internal Market. Based on the arguments presented above, preference, I think, should be given to the exemption method, since that is the method that best preserves the interest and aims of the Internal Market.

Although there are some issues within the directive, one positive thing is the fact that the legislator has chosen to use the term “distribution of profit” instead of “dividends”. This choice must be held to have increased the scope of the directive, since the term “distributions of profit” is widely regarded in international tax law to have a broader meaning than the term “dividends”. Thus, even though the directive doesn’t provide a definition of the term, it must be held that the directive in this regard is quite flexible and it will not require substantial amendments in the future to bring the scope of the directive up to date.

Another positive fact is that the Court now has given both article 4(1) and 5 of the directive direct effect. This will strengthen the directive considerably, since citizens of the Member States now may rely on these two provisions of the directive in front of their national courts. The effect of the directive upon the domestic legislation of the Member States will increase and it will increase the pressure upon the Member States to amend their legislation in order to comply with the provisions of the directive. As for the citizens, the fact that they will be able to rely on these provisions in front of their national court will ensure that they will benefit directly from the preferential treatment laid down by the directive.

8.2 Case law

From the case law presented above, it is possible to draw some conclusions. It is quite clear that the Court has adopted a specific method to assess whether the national legislation creates a restriction against one of the fundamental freedoms. The Court considers first whether the national legislation creates a difference in treatment of inbound or outbound dividend payments compared to domestic dividend payment. Then, the Court assesses the situation of the non-resident and resident to see if they are in a comparable situation to each other. The situation of a resident and a non-resident is comparable if the state of residence has chosen to exercise its taxing jurisdiction in respect of non-residents in a way that makes the situation of a non-resident comparable to the situation of a resident. This is right in principle, since two taxpayers both subject to tax in the same state must be held to be comparable. However, the liability to tax for residents and non-residents is based on two different connection factors, source and residence, which are not equally strong. The comparability of the two situations might thus be challenged in theory. But, if the Internal Market is to be achieved, one cannot make a distinction between two taxpayers based on these two connecting factors. The fundamental freedoms in the EC Treaty require that the same treatment is applied in the same situations and that a different treatment is applied in different situations. If residents and non-residents were able to be distinguished based on these connection factors, the Member States would be given a *carte blanche* to treat these differently and the fact that both of them would be subject to tax in a comparable way would not matter. I am thus of the opinion that the ECJ has chosen the right way to deal with the comparability issue.

If the situation of a resident and a non-resident is held to be comparable, then state must treat inbound and outbound dividend payments in the

same way as domestic dividend payments and it must also grant non-residents the same tax benefits as granted to residents. If that state has chosen to relieve double taxation for domestic taxpayers when they are receiving domestic dividend payments, the state must also grant the same preferential treatment to resident receiving inbound dividend payments. If the state has chosen not to levy a withholding tax on dividend payments within the state, the same treatment must be extended to outbound dividend payments. At the outset, there is thus a consistency in the case law as concerns the principles that the Court uses when it assesses the national legislation of the Member States. However, as shown above, the case law is marred by the inconsistency in the application of these principles. One may for example wonder why the Court considered the whole chain of events in *Manninen and Meilicke*, but not in the previous cases and you wonder why the Court held that the situation in *Kerckhaert Morres* couldn't be struck down since the difference in treatment was held to be due to the exercise in parallel of the fiscal sovereignty of two states; isn't all issues in the case law presented above due to this fact? It would thus be most welcomed that the Court in future cases concerning inbound and outbound dividend payments applies its reasoning, which in principle is correct, in a consistent manner.

As regards the inconsistency in the case law shaped by the ECJ, one must remember the task and the role that the Court has. It has been shown above that the Court is first and foremost an interpreter of the EC Treaty. That can be derived from the wording of article 234(1) EC, dealing with preliminary rulings, alone. The Court is not a law-making Court; it is only an interpreter of the EC Treaty. The Court determines the content of the fundamental freedoms, as they should have been understood from the time they entered into force. The Court does not create any new body of law. The holdings made by the Court can thus as such not be in consistency with each other. The Court thus decides the cases referred to it on a case-by-case basis and it does not assess the national legislation, it interprets the EC Treaty provisions. Therefore, there cannot be total consistency in the case law of the ECJ. With this in mind, it is regretful that the Member States are amending their national legislation as soon as the ECJ delivers a new judgement. As said before, it is only the content of the provisions of the EC Treaty that is determined. The Member States should thus, instead of amending their national legislation, seek to comply with the provisions in the EC Treaty with the guidance provided by the principles applied by the Court in its case law.

As presented above, the Court seemingly made the choice of source state entitlement in *ACT Test Claimants* and in the *FII Test Claimants*, however, that conclusion is not that obvious after the judgement by the Court in *Bouanich*, in which it left this line of reasoning. However, there seems to be a change in the way which the Court approaches dividend cases. The ECJ has first, apart from the judgement in the *Bouanich* case, given precedence to the taxation of the source state and second, it held that it could not deal with disparities between the taxation systems of the Member States that exists due to the exercise in parallel of the fiscal sovereignty of two Member States. It is not entirely clear why the Court has chosen this path, whether it is because it was influenced by the reasoning of AG

Geelhoed in ACT Test Claimants or by international tax law or some other reason. The fact that the Court held in Kerckhaert Morres that it could not solve differences in treatment that was due to the exercise in parallel of fiscal sovereignty has been rightly criticised. Taking an opposite view, this could be a statement from the Court to the Member States that the Court can no deal with disparities existing due to the lack of harmonization of direct tax law within the Community. The Court could be said to have adopted the view that it can deal with restrictions and discrimination, but not with disparities and it is now up to the Community legislator to act to remove these disparities. However, the fact that the Court has chosen which path to trail can only be positive and as seen above, it has been supported by some of the legal writers. One can only hope that the ECJ applies its reasoning consistently in the future cases concerning dividend payments.

8.3 Final remarks

This thesis has presented the treatment of dividend payments within the EC area, both where there is positive integration and where there is negative integration. As concerns the positive integration, it has been shown that, although the Parent-Subsidiary directive is of great importance as concerns the treatment of dividend payments on participation holdings and the fact that the scope of the directive has been widened as of late, there are still some issues that has to be addressed by the Community legislator. The main issue to address in the years ahead is the fact that the Community has not chosen which way it will take as concerns the relieving of double taxation, giving the Member States the right to choose which one of the exemption and credit method to apply. It would be of great importance if the Community could agree on one of the methods, since that would harmonize this particular field of direct tax law further.

As concerns the case law shaped by the ECJ, it has been shown that the Court has adopted a clear line of reasoning when it deals with cases that concerns inbound and outbound dividend payments. When a state has made non-residents of that state subject to tax on dividend payments, they are comparable to residents and must be granted the same treatment or at least not be subject to a higher liability to tax than residents. The Court has also decided to give precedence to source state taxation and held that it can not deal with disparities between the Member States due to the lack of harmonization. However, this thesis has shown that there are an inconsistency in the case law of the ECJ and one can only hope that the path chosen will be applied consistently in the future. One should not however underestimate the importance of the negative integration shaped by the case law of the ECJ, which is much needed due to the lack of positive integration from the Community legislator.

This thesis has provided an overview of the treatment of inbound and outbound dividend payments within the EU, both within the scope of the Parent-Subsidiary directive and in the light of the fundamental freedoms in the EC Treaty. As regards the Parent-Subsidiary directive, it has been shown that, although the scope of the directive has been widened in recent years, with some important amendments made in 2003, there are still some issues

to address. The writer suggests that the Community legislator considers the wording of the directive, which in some parts is still ambiguous. More importantly, a choice has to be made between the exemption and the credit method, as these two methods are based on a fundamentally different reasoning. True harmonization can only be achieved if one of the methods is preferred to the other. The writer suggests, based on the findings in this thesis, that the exemption method is preferred to the credit method, as that method best ascertains that the aim of the directive is fulfilled.

As regards the treatment of outbound and inbound dividend payments in the light of the fundamental freedoms, it has been shown that the case law produced by the Court is not consistent. However, it has also been shown that, with regard to the task and role of the ECJ, this is natural. It decides the cases brought before it on a case-by-case basis and it doesn't apply or interpret the national legislation of the Member States, it interprets the provisions in the EC Treaty and determines the content of them. Despite this inconsistency, the ECJ has adopted a clear reasoning and principles, which it applies when it decides cases concerning dividend payments. It has also, in its most recent case law, made the choice to apply the principle of source state entitlement and it has clearly stated that there exists disparities between the taxation systems of the Member States, due to the lack of positive harmonization, that the Court cannot deal with. Based on these findings, the writer suggests that the Court remains true to the path it has chosen and continues to apply the principle of source state entitlement and also remains true to the task given to it by the EC Treaty. The writer also urges the Member States to enact more legal acts to improve the positive integration of the taxation systems of the Member States.

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