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EU Direct Tax Newsalert

CJEU judgment on EU law compatibility of German trade tax exemption for third country dividends

On 20 September 2018, the Court of Justice of the European Union (CJEU) issued its judgment in *EV* (C-685/16). The underlying question of the case was whether the "activity clause" in the German trade tax act for third country sourced dividends is contrary to the free movement of capital (Art. 63 of the Treaty on the Functioning of the EU - TFEU).

Facts

The plaintiff, a company resident in Germany, held all of the shares in an Australian corporation. The Australian corporation distributed dividends to Germany, of which 95% were exempt for German corporate income tax purposes. However, for trade tax purposes, an exemption was only granted if certain conditions were met. One of the conditions for obtaining the trade tax exemption was that the distributing subsidiary generates "active income" according to the definition in the German Foreign Tax Act.

In the underlying case, the tax authorities took the position that the distribution was funded from passive income sources. Therefore, no trade tax exemption for the received dividends was granted. In contrast, no such "activity test" existed under the dividend exemption applicable to domestic dividends.

Due to this different treatment, the plaintiff argued that the rule was contrary to the free movement of capital.

Judgment

The CJEU stated that the different treatment of domestic and foreign dividends from third countries constituted a restriction of the free movement of capital.

Furthermore, the CJEU investigated in more detail to what extent this infringement of the free movement of capital was grandfathered under the so-called "standstill clause" (Art. 64 TFEU). Since the legislation was already in place before 31

December 1993, the CJEU needed to decide whether legislative changes of the provision in the meantime led to the non-application of the standstill clause.

On the one hand, the trade tax exemption for dividends from third countries was subject to changes (i.e. the threshold was increased from 10% to 15%). On the other hand, the German dividend taxation system was revised leading to a change from an imputation system to a shareholder relief system. Due to these changes, the CJEU held that the standstill clause was not applicable.

The CJEU tested whether there was a justification for the restriction. The German Government argued among others that the legislation was in place to counter abusive tax planning. However, the CJEU rejected this argument on the basis that the trade tax provision under scrutiny assumed that an abuse of law existed in any case if dividends were not paid out of active income (i.e. the taxpayer did not have the chance to prove the opposite).

Takeaway

The judgment in the *EV* case has significant practical impact on the tax treatment of third country sourced dividends for German trade tax purposes. It sets up the principle that an "activity clause" with no " motive test" is not in line with the fundamental freedoms of the TFEU if the provisions regulating the tax exemption for domestic dividends do not include such a clause.

Taxpayers facing additional taxes due to add backs for German trade tax purposes for "passive" third country sourced dividends should appeal against the relevant tax assessments.

Finally, the judgment reconfirms that the fundamental freedoms are highly relevant in respect of tax provisions of EU Member States that infringe the free movement of capital in relation to third countries.

