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By PwC Deutschland | 14 November 2012

Foreign tax credit precluded if domestic income exempt despite being taxed below nominal rate; freedom of establishment vs. capital m

The ECJ has held that freedoms of establishment and of capital movement preclude national legislation relieving foreign tax by credit as opposed to the exemption of domestic source income where the actual corporation tax paid by domestic companies is generally less than the nominal rate. It has also accepted the freedom of capital movement as relevant, unless the national legislation was aimed at controlling interests.

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The December 2006 *Test Claimants in the FII Group Litigation* judgment (case C-46/04) held national rules for the relief from double taxation of dividends in the hands of a corporation by exempting income of domestic source whilst crediting the foreign tax actually paid on those of foreign source to be acceptable in the face of the freedoms of establishment and of capital movement. Its main reasoning was that the two methods led to the same result where the subsidiary's tax rate is the same as, or higher than, that of the parent. If the parent's rate is higher, the exemption is more favourable than the credit; however, this was a consequence of the largely unharmonised corporation tax systems within the EU/EEA and was not a breach of one of the fundamental freedoms. *Test Claimants* have now returned to the fray with the follow-up question as to whether the original finding still holds good if the corporation tax charged in the country of the parent is regularly less than the nominal rate would seem to imply. This question was posed from a UK background of frequent corporation tax reliefs, often leading to little or no tax being paid. The effect of the exemption method is to exclude the privileged income from the subsidiary from the standard rate taxation to be levied on the parent. It thus passes the effects of reliefs and allowances available to operating companies up the holding chain. By contrast, the tax credit granted on foreign dividends is limited to the lower of the foreign tax actually paid or the UK tax actually chargeable. Foreign reliefs are thus effectively lost on distribution of the income to a foreign parent. The ECJ has now followed this argument and held there to be breaches of the fundamental freedoms of establishment and capital movement as long as the national court is satisfied that company profits in the member state concerned really are generally taxed at a lower level than that implied by the nominal rate. The court also confirmed that its finding also applies where the foreign burden was incurred by a sub-subsidiary, rather than the company distributing the dividend and where the burden on the dividend recipient was, in fact, borne by its own same country parent in consequence of group income elections.

This second *Test Claimants* case involved foreign source dividends from outside the EU/EEA. The question of the applicable fundamental freedom – of capital movement applicable worldwide for EU/EEA investors, or of establishment to the exclusion of non-EU/EEA countries – was thus of decisive importance. The ECJ has now held that an EU/EEA citizen or company can call on either, unless the legislation at issue is solely aimed at situations involving overall control over the subsidiary. The present case was only concerned with taxation of dividend income and the relevant rules did not change with the size or purpose of the investment. Thus the aggrieved party could claim either freedom with effectively the same result. This finding contrasts with that of *Scheunemann* (case C-31/11, judgment of July 19, 2012) denying a German inheritance tax relief for the preservation of family-held and managed businesses in respect of a wholly-owned investment in Canada. In the *Scheunemann* case the freedom of establishment was seen to eclipse that of capital movement, but was not relevant to a holding in a Canadian company.

The ECJ case reference is C-35/11 *Test Claimants in the FII Group Litigation*, judgment of November 13, 2012.

Keywords

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