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By PwC Deutschland | 15 November 2012

5% dividend expense disallowance restricts freedom of establishment only

The Supreme Tax Court has held that the 5% expense disallowance on tax-free dividends was, up to 2002, a restriction on the freedom of establishment rather than of capital movement and could thus be upheld in respect of a 33% share in a US company.

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Up to 2002, the disallowance of 5% of tax-free dividends received as a lump sum determination of effectively connected expenses was restricted to dividends exempted under a double tax treaty. Domestic dividends were exempted in 2001 under a different provision and the disallowed effectively connected expenses were those actually incurred. This difference in treatment was later held to be a restriction on the freedom of establishment; thus the 5% disallowance could no longer be applied to dividends on significant holdings in companies in other EU/EEA member states. A company with a 33.5% holding in a US company has claimed that the discrimination inherent in the 5% rule is also a restriction on the free movement of capital and that the 5% disallowance should be disapplied in its case as well.

The Supreme Tax Court has now held that the relevant freedom for investments of 10% or more is that of establishment. A holding of at least 10% of the share capital is generally sufficient to give the investor "definite influence" over a company's affairs. Certainly, a 33% holding implies a greater interest in the company than the mere wish to receive dividends. Accordingly, the free movement of capital is not the point at issue. Since the freedom of establishment does not extend to an EU/EEA investor's right to set up operations in the USA, the 5% blanket disallowance does not infringe community law.

It should be noted that the discrimination was resolved for 2002 with a provision extending the 5% disallowance to all tax-free dividend income without regard to the reason for the exemption. This case thus has no direct relevance to dividend income earned thereafter, although it is useful as an indication of the hard and fast distinction between the two freedoms favoured by the Supreme Tax Court. The ECJ on the other hand appears to prefer a more individual approach – see the *Test Claimants* judgment **C-35/11** of November 13, 2012 summarised here under "From Europe".

Supreme Tax Court judgment I R 7/12 of August 28, 2012 published on November 14

Keywords

effectively connected, expense disallowance, freedom of establishment