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By PwC Deutschland | 07 November 2013

Denial of corporation tax credit for foreign dividend justified by systematic differences?

An ECJ advocate general has suggested the court recognise a restriction on the free movement of capital from the differing treatment of the corporation tax underlying domestic and foreign dividends, but hold it to be justified in the interests of maintaining the internationally agreed balance of taxing rights.

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Under the German system of corporation tax in force up to 2000 (imputation system) a dividend recipient grossed up the income with the corporation tax borne by the dividend payer. This grossed up amount was then added to the recipient's taxable income. The gross-up factor – representing the underlying corporation tax charge – was then deducted from the corporation, or income, tax due by the recipient. This was repeated for every onward distribution, so that, ultimately, each item of corporate income bore a single tax burden – at the personal income tax rate of the ultimate natural person dividend recipient. If, however, a recipient at any stage in the chain had no liability because of available loss relief, the tax credit resulted in a net claim on the tax office, payable in cash. Foreign dividends, by contrast were exempted from corporation tax, and for that reason no credit was given for underlying foreign tax. Accordingly, the foreign tax remained a final burden if the German corporation had losses.

A US registered corporation with losses, resident in Germany by virtue of its place of management, has now claimed that this denial of relief for dividends received from its wholly-owned subsidiaries in other EU/EEA member states as well as in other countries is an unwarranted restriction on its freedoms of establishment and of capital movement under the TEU and TFEU. The ECJ advocate general on the case has now the suggested that the court hold that a US corporation cannot claim freedom of establishment rights by virtue of its nationality. However, it can claim the right to free movement of capital as that right is not restricted to EU/EEA entities. Also that right is not, in this case, eclipsed by the right to freedom of establishment, as the point at issue – the German tax credit on a foreign dividend – is the same, regardless of the size of the holding. There is thus no distinction between a controlling interest and a small minority holding. The measure itself, the denial of refund of the corporation tax underlying the dividends received from foreign subsidiaries, is a restriction on the free movement of capital. However, this is justified by the need to maintain the internationally agreed balance of taxing rights. Requiring Germany to refund corporation tax paid abroad would upset this balance significantly.

As of 2001, Germany replaced her imputation system of corporation tax with a full exemption of dividend income in the hands of a recipient corporation (now, though, dependent on a minimum holding of 10%). Thus, taken literally, the point of the present opinion has since been lost, although there is still a parallel in the shape of the dividend withholding tax. That on German source dividends is credited against the corporation tax due as though it were a tax prepayment. A final balance in favour of the taxpayer will be refunded as an overpayment. The withholding tax deducted abroad is credited only against the incremental corporation tax actually due on the income. If no German tax is due, whether because the income is tax-free, or whether because of losses, the foreign withholding tax becomes an unrelieved final burden.

The ECJ caswe reference is C-47/12 *Kronos*, opinion of November 7, 2013.

Keywords

foreign dividend, free movement of capital, tax credit