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By PwC Deutschland | 23 June 2023

ECJ: Partial trade tax addback of portfolio dividends in 2001 upon exercise of block option

The trade tax addback of foreign portfolio dividends in the year 2001 is in line with the EU provision on the free movement of capital in Article 63 TFEU (formerly: Article 56 TEC). This was decided by the European Court of Justice in an answer to a preliminary request submitted by the Supreme Tax Court.

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Background

In an application dated April 2004, the plaintiff (*H Lebensversicherung*, a public law institution subject to corporation profits tax and trade tax, and which operates a life insurance company) exercised the so-called block option to which life and health insurance companies were entitled at the time. As a result, 20% of the dividend income from the portfolio investments in the foreign corporations were not to be taken as income when determining the profit relevant for corporation profits tax (cpt) purposes pursuant to Sec. 8b (1) of the Corporation Tax Act (CTA) in the version applicable in 2001. With reference to the add-back provision in Sec. 8 No. 5 Sentence 1 Trade Tax Act (TTA), however, the tax office – for the **assessment period 2001** - added back the 20% of the distributions received which were not subjected to corporation profits tax.

The block option was available as a result of the replacement of the imputation system in 2001 with the half-charge to income tax. The half-charge procedure of 2001 and its successors in 2008 and 2009, the 60% charge and the flat rate taxation (withholding tax), placed domestic and foreign dividends and capital gains on equal footing.

Reason for the preliminary request

In an earlier decision dated 6 March 2013 (I R 14/07), the Supreme Tax Court saw the trade tax addback provision (sec. 8 no. 5 TTA), **which applied to dividends from foreign shareholdings for the first time in the assessment period 2001**, as a disadvantage for shareholdings in foreign companies, as violating Art. 63 TFEU, since no such addback was applicable for domestic dividends in 2001. After further examination, though, the former case law appears doubtful to the Supreme Tax Court because portfolio dividends were taken into account fully for domestic and foreign shareholdings in 2001 for German TT purposes, since the block option was also applicable for domestic shareholdings for the first time in the assessment period 2002 (i.e. domestic dividends were fully taxable at shareholder level in 2001 for cpt and trade tax purposes irrespective of the trade tax addback). The starting point to determine the income subject to trade income tax is the income subject to cpt: Here, only 80% of the dividends were taken to taxable income. In consequence, the remaining 20% were added back for TT purposes.

ECJ decision

In its decision, the ECJ confirms the revised interpretation of the Supreme Tax Court and sees no infringement of the free movement of capital in the case referred. The ECJ therefore answered the question submitted by the Supreme Tax Court as follows: "*Article 63 TFEU must be interpreted **as not precluding** legislation of a Member State under which, when calculating the basis of assessment for a company's business tax, dividends from holdings of less than 10% in non-resident capital companies are to be added back to that basis of assessment, **if and to the extent** those dividends were deducted from that basis of assessment at a previous stage of that calculation, whereas dividends from comparable holdings in resident capital companies are included from the outset in the abovementioned basis of assessment (…)".*

The portfolio dividends - as in the present case - have in a first step been exempted from the basis for cpt which at the same time is also the starting point for determining the final income subject to trade tax (i. e.

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before certain specific adjustments as listed in the Trade Tax Act are applied). The difference in treatment, during the two stages of the calculation of the basis of assessment for trade income tax, between dividends distributed by resident companies and those paid by non-resident companies does not lead to unfavorable treatment of the latter in comparison with the former, since, in both cases, all the dividends are included in that basis of assessment.

The add-back of 20% of the dividends to the basis of assessment for trade incme tax, as contested by *H Lebensversicherung*, is intended to ensure that the dividends distributed by non-resident companies are subject to the same tax burden as those paid by resident companies by being included in their entirety in that basis of assessment.

The argument of *H Lebensversicherung* that a restriction on the free movement of capital stems from the complexity of the national legislation at issue and from the unpredictable nature of that legislation, on account of the reform and the fact that there was uncertainty regarding investment results solely with respect to investments in non-resident companies, could not be upheld before the ECJ. First, it is apparent to the ECJ, that the application of that legislation stems from the exercise of a right (block option) by *H Lebensversicherung*. Second, the arguments relating to the complexity of that legislation are not capable of demonstrating that the rules laid down by that legislation were impossible or excessively difficult to comply with when investing in non-resident companies.

The arguments put forward by *H Lebensversicherung* also sought to demonstrate that the national legislation at issue made **the resale** of holdings in a non-resident company more attractive than their maintenance, since, in the event of the resale of those holdings, the resulting capital gains would not have been subject to trade tax. However, in the opinion of the ECJ such arguments are not capable of demonstrating that dividend **distributions** by a non-resident company were subject to a disadvantage in comparison with those distributed by a resident company due to the maintenance of such holdings.

Source:

ECJ judgment of 22 June 2023 case **C-258/22** *H Lebensversicherung*

Note: The preliminary ruling and the final decision by the Supreme Tax Court in the case of dispute is of particular and direct relevance for the year 2001 alone, as the unequal treatment between domestic and foreign investment income no longer existed in 2002.

Keywords

portfolio dividend, trade tax addback