CLEARY GOTTLIEB

Alert Memo

OCTOBER 21, 2011

www.clearygottlieb.com

European Court of Justice Rules on Discriminatory Taxation of German Outbound Portfolio Dividends

The European Court of Justice decided on October 20, 2011 that Germany's tax treatment of outbound portfolio dividends infringes Article 56 EC and Article 40 of the EEA Agreement because withholding tax is imposed on outbound portfolio dividends while domestic dividends are effectively exempt from tax. The European Commission had already formally notified the Federal Republic of Germany on October 12, 2005 of its doubts regarding the compatibility of the German tax system with the guaranteed free movement of capital. Because Germany had failed to timely amend its tax laws, the Commission brought action against the Federal Republic on July 23, 2009 (C-284/09).

Dividends distributed by German corporations are subject to 26.375% German withholding tax. However, Germany grants a general exemption from corporate income tax relating to dividends received by tax-resident corporate shareholders.[1] The withholding tax is therefore refunded to domestic corporate shareholders.

By contrast, corporations that are not tax-resident in Germany do not benefit from this general exemption. They are only entitled to full relief from German withholding tax if the requirements of the EC Parent-Subsidiary Directive (or of a double taxation treaty that provides for 0% withholding tax) are met, and the EC Directive (and double taxation treaties) contain minimum participation requirements. Portfolio dividends are not privileged. Portfolio dividends of non-resident corporations only qualify for a refund reducing the withholding tax rate down to 15%. Consequently, Germany effectively imposes income tax on portfolio dividends received by non-resident corporations at a higher rate than on dividends received by resident corporations. However, tax-resident corporations have to pay municipal trade tax (at rates varying from 7 to 17%) on portfolio dividends.

The European Commission considered the German system discriminatory and not in compliance with the guaranteed free movement of capital. The Federal Republic of Germany mainly argued that the unequal treatment of outbound portfolio dividends does not violate EC law because (i) domestic dividends are taxed in two stages (at the corporate level and at the level of the final individual shareholder) and, consequently, outbound dividends should also be subject to the whole tax charge, (ii) Germany is entitled to safeguard its taxation rights with respect to German-source income and has concluded double taxation agreements with other EC Member States in order to allocate taxation rights, and (iii) domestic portfolio

[1] An amount of 5% of the dividends effectively remains subject to corporate income tax because such amount is deemed a non-deductible business expense.

© Cleary Gottlieb Steen & Hamilton LLP, 2011. All rights reserved.

This memorandum was prepared as a service to clients and other friends of Cleary Gottlieb to report on recent developments that may be of interest to them. The information in it is therefore general, and should not be considered or relied on as legal advice. Throughout this memorandum, "Cleary Gottlieb" and the "firm" refer to Cleary Gottlieb Steen & Hamilton LLP and its affiliated entities in certain jurisdictions, and the term "offices" includes offices of those affiliated entities.

dividends are subject to municipal trade tax and, therefore, do not effectively benefit from a lower tax burden than outbound portfolio dividends.

The ECJ dismissed these arguments. In particular, the ECJ concluded that Germany's double taxation agreements do not provide for a full refund of German withholding tax and, moreover, German withholding tax can only be credited against a foreign tax if and to the extent another Member State actually imposes tax on German-source dividend income. Consequently, an unequal treatment of outbound portfolio dividends cannot be denied because of the existence of double taxation agreements. With respect to trade tax, the ECJ gave short shrift to the matter, emphasizing that the existence of unrelated advantages does not result in the compatibility with EC law of an unequal treatment restricting the free movement of capital. The ECJ also stated that, where a Member State has chosen to effectively exempt domestic portfolio dividends from tax, it cannot rely on the argument that there is a need to safeguard its taxation rights. Last but not least, the ECJ determined that the unequal treatment of outbound portfolio dividends cannot be justified due to the need to maintain a coherent tax system. The ECJ pointed out that domestic dividends, which are taxed in two stages, benefit from a tax break until they are distributed to the final (individual) shareholder while outbound portfolio dividends do not benefit from a postponed taxation.

As a consequence of the ECJ decision, non-resident corporations that have received portfolio dividends net of German withholding tax should consider an application for a refund within applicable time-limits.

Germany can be expected either to reduce the domestic withholding tax rate on outbound portfolio dividends (at least with respect to recipients resident in the EC or EEA) or, alternatively, repeal the current corporate income tax exemption for domestic portfolio dividends.

* *
*

Please do not hesitate to contact Daniel Weyde (jweyde@cgsh.com) or Volker Junge (vjunge@cgsh.com) at our Frankfurt office (+49 69 97 10 30) if you are interested in this subject.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

CLEARY GOTTLIEB

Office Locations

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
T: +1 202 974 1500
F: +1 202 974 1999

PARIS
12, rue de Tilsitt
75008 Paris, France
T: +33 1 40 74 68 00
F: +33 1 40 74 68 88

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
T: +32 2 287 2000
F: +32 2 231 1661

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
T: +44 20 7614 2200
F: +44 20 7600 1698

MOSCOW
Cleary Gottlieb Steen & Hamilton LLC
Paveletskaya Square 2/3
Moscow, Russia 115054
T: +7 495 660 8500
F: +7 495 660 8505

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
T: +49 69 97103 0
F: +49 69 97103 199

COLOGNE
Theodor-Heuss-Ring 9
50688 Cologne, Germany
T: +49 221 80040 0
F: +49 221 80040 199

ROME
Piazza di Spagna 15
00187 Rome, Italy
T: +39 06 69 52 21
F: +39 06 69 20 06 65

MILAN
Via San Paolo 7
20121 Milan, Italy
T: +39 02 72 60 81
F: +39 02 86 98 44 40

HONG KONG
Bank of China Tower
One Garden Road
Hong Kong
T: +852 2521 4122
F: +852 2845 9026

BEIJING
Twin Towers – West (23rd Floor)
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
T: +86 10 5920 1000
F: +86 10 5879 3902

BUENOS AIRES
CGSH International Legal
Services, LLP-
Sucursal Argentina
Avda. Quintana 529, 4to piso
1129 Ciudad Autonoma de Buenos Aires
Argentina
T: +54 11 5556 8900
F: +54 11 5556 8999

SÃO PAULO
Cleary Gottlieb Steen & Hamilton
Consultores em Direito Estrangeiro
Rua Funchal, 418, 13 Andar
São Paulo, SP Brazil 04551-060
T: +55 11 2196 7200
F: +55 11 2196 7299