

Taxation of Cross-Border Portfolio Dividends in Austria: The Austrian Supreme Administrative Court Interprets EC Law

In this article, the authors discuss the Austrian Supreme Administrative Court's decision of 17 April 2008 wherein it was decided that the discriminatory treatment of cross-border intercompany portfolio dividends, in comparison to equivalent domestic dividends, constitutes a prohibited restriction of the free movement of capital, but that granting an indirect foreign tax credit can cure the breach of EC law.

1. Introduction

It has long been questioned in the tax literature whether or not the Austrian differentiation between domestic and cross-border intercompany dividends constitutes a prohibited restriction of the free movement of capital (Art. 56 of the EC Treaty). In its judgment of 13 January 2005,¹ the Tax Senate (UFS) of Linz held that the differentiation does amount to a prohibited discrimination and that taxpayers whose holdings do not fulfil the minimum requirements are nevertheless entitled to an analogous application of the exemption available in domestic situations. The tax administration appealed the Tax Senate's judgment and on 17 April 2008² the Austrian Supreme Administrative Court (VwGH) gave its final decision without referring the case to the European Court of Justice (ECJ). The VwGH upheld the finding that there was discrimination, but ruled, however, that granting an indirect foreign tax credit can cure the breach.

2. The Austrian Participation Exemption Regime in Light of EC law

2.1. The legal framework

Sec. 10 of the Austrian Corporation Tax Act (KStG), which was substantially amended by the Budget Supplementary Act 2003³ and last amended by the Tax Amendment Act 2005,⁴ contains a twofold participation exemption regime.⁵ Sec. 10(1) of the KStG deals with national participations and provides for an exemption of profit distributions received at the corporate shareholder level, without imposing a minimum holding requirement or a minimum holding period.⁶ Capital gains, however, are

*** Priv.-Doz., DDr., LL.M. The author can be contacted at georg.kofler@jku.at.

**** Dr., LL.M., Attorney at Law and Certified Public Tax Adviser, Partner with Wolf Theiss Rechtsanwälte, Vienna. The author can be contacted at clemens.schindler@wolftheiss.com.

1. UFS Linz, 13 January 2005, RV/0279-L/04, available (in German) at <https://findok.bmf.gv.at>. For a discussion of this decision see Georg Kofler and Gerald Toifl, "Austria's Differential Treatment of Domestic and Foreign Inter-Company Dividends Infringes the EU's Free Movement of Capital", *European Taxation* 6 (2005), p. 232 et seq.

2. VwGH, 17 April 2008, 2008/15/0064, available (in German) at <http://www.ris.bka.gv.at/vwgh>. The literature on the Supreme Administrative Court's decision is already extensive and is still growing: Reinhold Beiser, "VwGH: Anrechnungsmethode bei Ausschüttungen aus ausländischen Minderheitsanteilen", *Steuer- und Wirtschaftskartei* 18 (2008), p. S 511 et seq.; Thomas Kühbacher, "Die Vermeidung einer Doppelbesteuerung bei ausländischen Portfoliobeteiligungen im KStG", *Österreichische Steuerzeitung* 13 (2008), p. 308 et seq.; Thomas Kühbacher, "Erfordert § 10 Abs. 2 KStG bei ausländischen Portfoliobeteiligungen einen Anrechnungsvortrag?", *Steuer & Wirtschaft International* 9 (2008), p. 387 et seq.; Marco Laudacher, "§ 10 Abs. 2 KStG und Portfoliobeteiligungen: Beschränkung der Kapitalverkehrsfreiheit?", *Steuer & Wirtschaft International* 6 (2008), p. 259 et seq.; Ernst Marschner, "EuGH in *Columbus* und Sammelverfahren *CFC and Dividend* sowie VwGH zu § 10 Abs 2 KStG: Der ungebremste Siegeszug der Anrechnungsmethode", *Finanzjournal* 7/8 (2008), p. 260 et seq.; Christian Massoner, "Anrechnungsmethode bei ausländischen Dividendeneinkünften aus Minderheitsbeteiligungen 'dank' normerhaltender Reduktion", *ecolex* 6 (2008), p. 573 et seq.; Christian Massoner and Birgit Stürzlinger, "Anrechnungsmethode als geringster und gemeinschaftsrechtskonformer Eingriff in die Besteuerung von Portfoliobeteiligungen?", *Steuer & Wirtschaft International* 9 (2008), p. 400 et seq.; Robert Miggautsch, "VwGH: Internationales Schachtelpatent widerspricht Gemeinschaftsrecht!", *ecolex* 7 (2008), p. 669 et seq.; Ulrich Petrag, "Internationale Schachtelpatent verstößt gegen die Kapitalverkehrsfreiheit", *Zeitschrift für Recht und Rechnungswesen* 6 (2008), p. 163 et seq.; Markus Christoph Stefaner, "Internationale Schachteldividenden – Beseitigung der Diskriminierung?", *GeS* 4 (2008), p. 164 et seq.; Nikolaus Zorn, "VwGH: Auslandsdividenden und Gemeinschaftsrecht", *Recht der Wirtschaft* 6 (2008), p. 424 et seq.; and Nikolaus Zorn, "Dividenden aus Auslandsbeteiligungen von Körperschaften", *Steuer- und Wirtschaftskartei* 16 (2008), p. S 467 et seq.

3. BGBl (Federal Gazette) I 71/2003. For these amendments see, for example, Claus Staringer, "Beteiligungserträge im Körperschaftsteuerrecht", in Romuald Bertl et al. (eds.), *Beteiligungen in Rechnungswesen und Besteuerung* (Vienna: Linde, 2004), p. 165 et seq.; Sabine Kristen and Thomas Passeyrer, "Verhaltenskodex für die Unternehmensbesteuerung: Die geplanten Änderungen der Bestimmungen zum internationalen Schachtelpatent", *Steuer & Wirtschaft International* 5 (2003), p. 225 et seq.; Sabine Kristen and Thomas Passeyrer, "Follow-Up zu den Neuerungen zum internationalen Schachtelpatent nach der Regierungsvorlage zum Budgetbegleitgesetz 2003", *Steuer & Wirtschaft International* 6 (2003), p. 279 et seq.; and Sabine Kristen and Thomas Passeyrer, "International Holding Regime Revised", *European Taxation* 9 (2003), p. 326 et seq.

4. BGBl (Federal Gazette) I 161/2005.

5. See, for example, Sabine Kristen and Thomas Passeyrer, "Internal Holding Regime Revised", note 3, p. 326 et seq.; Gerald Gahleitner and Roland Fugger, "Changes to Austria's Tax Law Affecting Holding Structures", *Bulletin For International Fiscal Documentation* 11 (2003), p. 542 et seq.; Dietmar Aigner and Georg Kofler, "Internationale Schachtelpatenten – Neuregelung durch das Budgetbegleitgesetz 2003", *ecolex* 7 (2003), p. 485 et seq.; and Clemens Hasenauer and Nina Schütte, "Neuerungen zur Besteuerung von ausländischen Kapitalerträgen und zum internationalen Schachtelpatent in Österreich", *Internationales Steuerrecht* 24 (2003), p. 845 et seq.

6. Sec. 10(1) of the KStG also applies to distributions from mere holding subsidiaries that have no active business but engage in asset management resulting in passive income only. Such domestic holding companies are generally accepted under Austrian tax law; accordingly the corporate veil is not pierced for tax purposes. See Verena Trenkwalder, "Missbrauchsreflex bei

* Mag., Assistant Professor, University of Linz. The author can be contacted at thomas.bieber@jku.at.

** MMag., Assistant Professor, University of Linz. The author can be contacted at werner.haslehner@jku.at.

not exempted under Sec. 10(1) of the KStG and, thus, are fully taxable at the ordinary corporate tax rate of 25%. Sec. 10(2) of the KStG, which is based on Art. 4 of the EC Parent-Subsidiary Directive⁷ and was first implemented into Austrian law at the time of Austria's accession to the European Union in 1995,⁸ is directed at inbound distributions from EU and third-country subsidiaries. It grants an exemption if the Austrian corporate shareholder holds, directly or indirectly,⁹ at least 10%¹⁰ of the capital for a minimum holding period of one year.¹¹ Furthermore, and in contrast to the national participation exemption under Sec. 10(1) of the KStG, capital gains and losses derived from the alienation, appreciation or depreciation of an international participation are treated as tax neutral, unless the taxpayer otherwise elects (Sec. 10(3) of the KStG). In addition, the anti-avoidance provision in Sec. 10(4) of the KStG only applies to cross-border situations and provides for a switchover to the indirect credit system if the foreign distributing company derives mainly passive income and is subject to low taxation in its country of residence.¹²

2.2. The facts of the case

The claimant is an Austrian resident stock corporation that held – via a domestic transparent investment fund – portfolio participations in various companies resident both in the European Union and in third countries. The claimant received distributions of the domestic fund stemming from cross-border portfolio dividends. As the participation threshold was not met, Sec. 10(2) of the KStG did not apply and the dividends channelled through the fund were, therefore, fully taxable under Austrian corporate tax law.¹³ If the claimant had, however, received, via the fund, portfolio dividends of domestic companies, the national participation exemption of Sec. 10(1) of the KStG would have applied. The claimant argued, therefore, that the different treatment, i.e. an exemption system applicable without restriction in a purely domestic situation versus an exemption system subject to minimum holding requirements in a cross-border situation, leads to a less favourable treatment of the cross-border situation. This less beneficial treatment, it argued, hinders the exercise of both the free movement of capital (Art. 56 of the EC Treaty) and the freedom of establishment (Arts. 43 and 48 of the EC Treaty).

2.3. The Supreme Administrative Court's judgment

2.3.1. Overview

As expected, the VwGH agreed with the Tax Senate that the Austrian differentiation infringes on the free movement of capital and cannot be justified on the basis of either the need for coherence of the tax system or the fact that the discriminatory regime implements the EC Parent-Subsidiary Directive. The Supreme Administrative Court held, however, that only primary EC law supersedes domestic law and that it is for the domestic court to determine the legal ramifications of such "suppression" in a way that best fits the policy decisions of the domes-

tic legislator. In doing so, the VwGH deviated from the Tax Senate's holding. It focused on the portfolio shareholding in the case at hand and found that, in light of the ECJ's decision in *FII Group Litigation*,¹⁴ the incompatibility of Austria's regime with EC law can be cured by granting an (indirect) foreign tax credit instead of an exemption. Any remaining disadvantage would then be based on mere disparities, such as different tax rates or bases in the different Member States. The Supreme Administrative Court's judgment contains numerous interesting arguments, which are summarized and analysed below.

2.3.2. Application of the free movement of capital

The VwGH first examined whether or not the EC Treaty provisions on the freedom of establishment apply. For that purpose, the court relied on the ECJ's jurisprudence since *Baars*,¹⁵ according to which a national provision falls within the scope of the freedom of establishment if it applies to holdings of nationals of the Member State concerned in the capital of a company established in another Member State that give them definite influence on the company's decisions and allow them to determine its activities.¹⁶ In the case at issue, the Austrian corporate shareholder was only a portfolio shareholder without a definite influence over the foreign company's decisions. The VwGH concluded, therefore, that the claimant cannot rely on the freedom of establishment. It then went on to conclude, however, that the free movement of capital is applicable and relied on the ECJ's decision in *Commission v. The Netherlands*¹⁷ to determine the scope of application of the free movement of capital:

In the absence of a definition in the EC Treaty of "movements of capital" for the purposes of Article 56(1) EC, the Court has recognised the nomenclature annexed to Council Directive

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funktionslosen Gesellschaften gerechtfertigt?", in Michael Lang and Heinz Jirousek (eds.), *Praxis des internationalen Steuerrechts*, Festschrift for Helmut Loukota (Vienna: Linde, 2005), p. 583.

7. Directive 90/435/EEC of 23 July 1990.

8. BGBI (Federal Gazette) 681/1994.

9. Especially via a partnership or in conjunction with holdings of other subsidiaries. Before the Budget Supplementary Act 2003, Sec. 10(2) of the KStG granted an exemption only if the Austrian corporate shareholder held directly at least 25% of the capital for a minimum holding period of two years.

10. 25% before the amendments in 2003.

11. Two years before the amendments in 2003.

12. See 3.3.

13. The case dealt with the special situation of foreign dividends that were being channelled through an investment fund under the law prior to the Budget Supplementary Law 2003, Federal Gazette I 2003/71, which provided for a minimum holding of 25% (now 10%) and a minimum holding period of two years (now one year); the findings, however, are equally applicable to the current law.

14. ECJ, 12 December 2006, Case C-446/04, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*.

15. ECJ, 13 April 2000, Case C-251/98, *C. Baars v. Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem*, Para. 21 et seq.

16. For this test of application of the freedom of establishment see, for example, *Baars*, note 15, Paras. 21 and 22; ECJ, 21 November 2002, Case C-436/00, *X. Y v. Rikskatteverket*, Paras. 37 and 66-68; ECJ, 12 September 2006, Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*, Para. 31; ECJ, 12 December 2006, Case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation v. Commissioners of Inland Revenue*, Para. 39; and *FII Group Litigation*, note 14, Para. 58.

17. ECJ, 28 September 2006, Joined Cases C-282/04 and C-283/04, *Commission v. The Netherlands*.

88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty ... as having indicative value. Movements of capital for the purposes of Article 56(1) EC thus include in particular direct investments in the form of participation in an undertaking through the holding of shares which confers the possibility of effectively participating in its management and control ("direct" investments) and the acquisition of shares on the capital market solely with the intention of making a financial investment without any intention to influence the management and control of the undertaking ("portfolio" investments).¹⁸

Against this background, the VwGH classified the shareholdings at issue as "portfolio investments" that do not confer a definite influence over the dividend-paying company's decisions and, therefore, have to be examined in light of the EC Treaty's free movement of capital provisions. The court, however, also considered in *obiter dictum* that the free movement of capital (and hence potential protection in a third-country setting) would not apply if the shareholding were *in fact* a holding that is protected by the freedom of establishment, irrespective of whether or not the domestic rule covers portfolio holdings and controlling interests alike.¹⁹

2.3.3. *Restriction of the free movement of capital*

In considering a possible infringement of the EC Treaty's free movement of capital, the VwGH referred to the ECJ's landmark decision in *Manninen*²⁰ which involved an inbound dividend situation and where the ECJ pointed out that:

... in the face of a tax rule which takes account of the corporation tax owed by a company in order to prevent double taxation of the profits distributed, shareholders who are fully taxable in Finland find themselves in a comparable situation, whether or not they receive dividends from a company established in that Member State or from a company established in Sweden.²¹

It applied this holding to the present case and ascertained that corporate shareholders that are fully taxable in Austria and that receive dividends from domestic companies are in a comparable situation to corporate shareholders that are fully taxable in Austria and receive dividends from foreign companies. Since Sec. 10 KStG treats Austrian corporate shareholders in comparable situations differently by defining different exemption systems for domestic and cross-border portfolio dividends,²² such different treatment of comparable domestic and cross-border portfolio dividends constitutes a restriction on the free movement of capital. It can, therefore, only prevail if (1) it can be justified by pressing reasons of public interest and (2) fulfils the proportionality test.²³

2.3.4. *Justification of the restrictive measure*

The VwGH first dismissed the argument that a less favourable treatment of cross-border portfolio dividends can be justified in light of Art. 58 of the EC Treaty. Art. 58(1)(a) of the EC Treaty explicitly refers to permissible restrictions, whilst Art. 58(3) of the EC Treaty prohibits arbitrary discrimination and disguised restrictions.²⁴ Referring to the cases of *Verkooijen*²⁵ and *Manninen*,²⁶ the VwGH pointed out that if taxpayers are in comparable situations, Art. 58(1)(a) of the EC Treaty

does not grant Austria any additional leeway beyond the "rule of reason" in justifying restrictive measures. Referring to the ECJ's holding in *Manninen*,²⁷ the VwGH concluded that it would not threaten the coherence of the Austrian participation exemption regime if the relief granted to Austrian corporate shareholders receiving portfolio dividends from resident companies was extended to Austrian corporate shareholders receiving portfolio dividends from non-resident companies.²⁸ In passing, the VwGH finally noted that the EC Parent-Subsidiary Directive, which also foresees a minimum holding requirement, cannot be relied on as a justification.²⁹

2.3.5. *Legal ramifications: indirect tax credit method for portfolio dividends*

In a final step, the VwGH emphasized the general principle that EC law takes precedence over national law and is binding on national authorities. In this respect, the VwGH found that it is for the domestic court to determine the legal ramifications of such "suppression" of domestic law that is superseded by primary EC law in a way that best suits the policy of the domestic legislator. This means that if several solutions fulfilling the provisions of EC law are available, the solution that best fits within the national tax policy should be chosen. In other words, the modification of a national tax rule has to comply with EC law, on the one hand, and uphold the domestic tax policy, on the other.³⁰

18. Id., Para. 19.

19. This position was confirmed in the ECJ's subsequent decision in ECJ, 26 June 2008, Case C-284/06, *Finanzamt Hamburg-Am Tierpark v. Burda GmbH*, Para. 71 et seq.; see also 3.2.

20. ECJ, 7 September 2004, Case C-319/02, *Petri Manninen*.

21. Id., Para. 36.

22. See 2.1.

23. See, for example, ECJ, 28 January 1992, Case C-204/90, *Hanns-Martin Bachmann v. State of Belgium*, Para. 21 et seq.; ECJ, 28 January 1992, Case C-300/90, *Commission v. Belgium*, Para. 14 et seq.; and ECJ, 3 October 2002, Case C-136/00, *Danner v. Finland*, Para. 33 et seq. and Para. 44 et seq.

24. See Georg Kofler and Gerald Toifl, note 1, p. 235.

25. ECJ, 6 June 2000, Case C-35/98, *Staatssecretaris van Financiën v. B.G.M. Verkooijen*, Para. 42 et seq.

26. *Manninen*, note 20, Para. 29.

27. *Manninen*, note 20, Para. 46.

28. In regards to the "cohesion" of the tax system as a ground of justification see, for example, Georg Kofler, *Doppelbesteuerungsabkommen und Europäisches Gemeinschaftsrecht* (Vienna: Linde, 2007), p. 1001 et seq.

29. For a detailed analysis of this issue see Georg Kofler and Gerald Toifl, note 1, p. 235 et seq. and Clemens Philipp Schindler, "EU Report" in *Cahiers de Droit Fiscal International*, Vol. 90b (Amersfoort: Sdu Fiscale, 2005), p. 53 et seq. and p. 66 et seq.

30. For more detail, see Dietmar Gosch, "Vielerlei Gleichheiten – Das Steuerrecht im Spannungsfeld von bilateralen, supranationalen und verfassungsrechtlichen Anforderungen", *Deutsches Steuerrecht* 36 (2007), p. 1555 et seq. From a domestic perspective, compare also Sec. 140 of the Austrian Federal Constitutional Act and the case law of the Austrian Constitutional Court (VfGH), 7 March 2002, G 219/01, VfSlg 2002/16474.

As for the issue at hand, the Tax Senate of Linz had ruled that the precedence of EC law and the resulting “suppression” of the discriminatory domestic measure leads to the conclusion that the exemption method granted in respect to domestic distributions must be extended to cross-border inbound distributions in situations where the requirements of Sec. 10(2) of the KStG are not met. The VwGH did not, however, endorse this solution. An extension of the exemption method to cross-border portfolio dividends would infringe the fundamental national tax policy decision to grant an exemption only for “qualified” cross-border investments that further cross-border direct investment, but not mere portfolio investments.³¹ In reflecting on the relationship between the exemption method and the indirect tax credit method, the VwGH referred to the ECJ’s judgment in *FII Group Litigation*,³² where the ECJ pointed out that Member States may provide for an exemption method for domestic dividends and an imputation system in cross-border situations provided two conditions are met.³³ First, foreign-source dividends cannot be subject to a higher rate of tax than the rate applicable to domestic-sourced dividends.³⁴ Second, the recipient company’s state of residence must grant an ordinary tax credit.³⁵ This means that if the distributing company pays tax on its profits at a lower level than the tax levied in the Member State of the recipient, the recipient company’s state must grant a tax credit corresponding to the tax paid by the distributing company in the Member State where it is resident.³⁶ Thus, if the profits are subject to a higher tax rate in the distributing company’s Member State, the recipient company’s Member State is obliged to give a tax credit only up to the limit of the amount of corporate tax that the company receiving the dividends is liable for.³⁷

Against this background, the Court concluded that the incompatibility of Austria’s regime with EC law can be cured by granting an (indirect) foreign tax credit instead of an exemption. Any remaining disadvantage would then be based on mere disparities, such as different tax rates or bases in the different Member States. Sec. 10(2) of the KStG, therefore, contains a twofold relief system for cross-border distributions. If the Austrian corporate shareholder holds more than 10% of the share capital of the foreign company, the exemption method applies. If the Austrian corporate shareholder holds less than 10% of the share capital of the foreign EU company, the indirect tax credit method applies. The court consolidates its arguments by drawing a parallel with the ECJ’s judgment in *Columbus Container*,³⁸ wherein the ECJ had to deal with a German anti-avoidance provision³⁹ that provided for a unilateral treaty override in the form of a switchover from the tax treaty exemption method to the indirect tax credit method in permanent establishment situations.⁴⁰ The ECJ pointed out that the “switchover effect” triggered by the application of the indirect tax credit method does not necessarily constitute a restriction because it merely subjects the profits made by such partnerships to the same tax rate as profits made by partnerships established in Germany. Likewise, the VwGH pointed out that Sec. 10(4) of the KStG, which foresees a

switchover from the exemption method to the indirect tax credit method if the foreign distributing company derives mainly certain passive income and is subject to low taxation in its country of residence, implies that, similar to portfolio holdings, investments that are not “active” do not warrant an exemption.

3. Analysis and Consequences

3.1. Indirect tax credit method for portfolio dividends from EU companies

It came as no surprise that the VwGH sided with the Tax Senate of Linz⁴¹ and tax literature,⁴² thus holding that the differentiation between a purely domestic situation and cross-border distributions constitutes an unjustifiable restriction, prohibited by the provisions on the free movement of capital contained in the EC Treaty. Such a conclusion was already implied in the ECJ’s judgments in *Commission v. France*,⁴³ *Lenz*⁴⁴ and *Manninen*.⁴⁵ Also, in light of *Bosal*,⁴⁶ *Keller Holding*,⁴⁷ *ACT Group Litigation*⁴⁸ and *Amurta*,⁴⁹ the EC Parent-Subsidiary Directive, on which the Austrian international participation regime is based, cannot be relied on as a justification for such an infringement of primary EC law.⁵⁰

The conclusion drawn by the Austrian Supreme Administrative Court regarding the legal ramifications is, however, novel. The ECJ has only quite recently, in *FII Group Litigation*⁵¹ and *Columbus Container Services*,⁵² explicitly found that a parallel application of the exemption method for domestic situations and the indirect tax credit method for cross-border situations can be in conformity with the fundamental freedoms, since any

31. This position was explicitly taken in the legislative materials; see ErlRV 622 BlgNR XVII. GP, 19.

32. *FII Group Litigation*, note 14.

33. See Tom O’Shea, “Dividend Taxation Post-Manninen: Shifting Sands or Solid Foundations?”, 45 *Tax Notes International* (5 March, 2007), p. 887, at p. 889.

34. *FII Group Litigation*, note 14, Para. 49.

35. *Id.*, Para. 50.

36. *Id.*, Para. 51.

37. *Id.*, Para. 52.

38. ECJ, 6 December 2007, Case C-298/05, *Columbus Container Services*.

39. Sec. 20(2) and (3) of the German Foreign Tax Act (AStG).

40. *Columbus Container Services*, note 38, Para. 37.

41. UFS Linz, 13 January 2005, RV/0279-L/04, available at <https://findok.bmf.gv.at>.

42. See, for example, Georg Kofler and Michael Tumpel, “Double Taxation Conventions and European Directives in the Direct Tax Area”, in Michael Lang, Josef Schuch and Claus Staringer (eds.), *Tax Treaty Law and EC Law* (Vienna: Linde, 2007), p. 200 et seq. and the further references cited therein.

43. ECJ, 4 March 2004, Case C-334/02, *Commission of the European Communities v. French Republic*.

44. ECJ, 15 July 2004, Case C-315/02, *Anneliese Lenz v. Finanzlandesdirektion für Tirol*.

45. *Manninen*, note 20.

46. ECJ, 18 September 2003, Case C-168/01, *Bosal Holding BV v. Staatssecretaris van Financiën*.

47. ECJ, 23 February 2006, Case C-471/04, *Keller Holding*.

48. *ACT Group Litigation*, note 16, Para. 54.

49. ECJ, 8 November 2007, Case C-379/05, *Amurta SGPS v. Inspecteur van de Belastingdienst/Amsterdam*, Paras. 20-24.

50. For an extensive discussion, see Georg Kofler and Gerald Toifl, note 1, p. 235 et seq. and Clemens Philipp Schindler, “EU Report”, note 29.

51. *FII Group Litigation*, note 14.

52. *Columbus Container Services*, note 38.

resulting disadvantage in the form of residual taxation can be reduced to a mere disparity. Likewise, the exemption and the indirect tax credit methods provided for in Art. 4 of the EC Parent-Subsidiary Directive are considered to be equivalent and it is left to the discretion of the Member States to decide the method that should apply. It is also virtually indisputable that, under the EC Parent-Subsidiary Directive, a Member State may provide for the application of both methods, one in relation with some Member States and the other in relation with other Member States. In addition, it is quite permissible to provide for the application of both methods in relation to one and the same Member State. The method that is to be applied in these circumstances would be determined according to specified conditions, for example foreign low taxation.⁵³

The VwGH's synthesis of *FII Group Litigation* and *Columbus Container* lead the court to the conclusion that an indirect credit is just as good as an exemption, and that the granting of an indirect credit satisfies the requirements of EC law. In light of *FII Group Litigation*, however, an EC-compatible application of the credit method requires (1) "that the foreign-source dividends are not subject in that Member State to a higher rate of tax than the rate which applies to nationally sourced dividends"⁵⁴ and (2) "that the tax credit is at least equal to the amount paid in the Member State of the company making the distribution, up to the limit of the tax charged in the Member State of the company receiving the dividends".⁵⁵ These requirements lead to several conclusions, some of which have already been addressed in a recent information issued by the Austrian Ministry of Finance.⁵⁶

First, in light of *FII Group Litigation*, determining whether an exemption and credit are equivalent obviously also requires a determination of the cumulative tax burden of both the dividend distributing company and the corporate recipient.⁵⁷ Indeed, conceptually, one cannot only compare the tax burdens of the dividend receiving company under an exemption system with the tax burden of such a company under a credit system.⁵⁸ As the ECJ pointed out, "it is for the national court to determine whether the tax rates are indeed the same and whether different levels of taxation occur only in certain cases by reason of a change to the tax base as a result of certain exceptional reliefs".⁵⁹ If, therefore, the tax paid in a domestic setting would be lower than the standard tax rate because of certain tax reliefs granted to the dividend distributing company, the application of a credit system in the cross-border situation could be discriminatory if the foreign jurisdiction has the same tax reliefs (for example, exemptions for inter-company dividends or for profits of foreign permanent establishments) as the residence country of the parent company. In such a situation, the foreign tax advantage would be eliminated under the credit system, whereas the exemption would prevail in a domestic setting, even though both countries employ identical tax systems. The disadvantage would, thus, not be the result of a mere disparity, as the ECJ had suggested in *FII Group Litigation*. The ECJ's decision,

therefore, seems to require an analysis of each individual case, an investigation the VwGH has not undertaken.⁶⁰ According to an information published by the Austrian Ministry of Finance,⁶¹ however, this potential problem is mitigated insofar as the foreign tax is generally deemed to represent full taxation of the taxpayer's profit share at the foreign nominal tax rate.⁶² Nevertheless, it is anticipated that this issue will be referred to the ECJ in the near future.

Second, *FII Group Litigation* requires that the foreign taxes that can be credited against the Austrian corporate tax be clarified. The judgment of the VwGH does not provide any information regarding this matter.⁶³ According to information published by the Austrian Ministry of Finance,⁶⁴ however, the tax credit shall include the corporate tax, as well as withholding taxes paid on the distributed dividends by the foreign company according to an applicable tax treaty.⁶⁵ In the tax literature it has also been argued that a foreign trade tax should be included in the credit.⁶⁶ It is, however, an open issue whether or not *FII Group Litigation* forces Austria to accept a credit carry-forward in a loss situation of the parent company to avoid an intertemporal discrimination.⁶⁷

There seems to be broad consensus among Austrian scholars that the judgment of the VwGH, in principle, follows along the lines set by the ECJ in its earlier deci-

53. See Kofler, note 28, p. 837 et seq. with further references.

54. *FII Group Litigation*, note 14, Para. 49.

55. Id., Para. 57.

56. This information (BMF-010216/0090-VI/6/2008) was published on 13 June 2008; it is available (in German) at <https://findok.bmf.gv.at>, and was reprinted in *Finanzjournal* 7/8 (2008), p. 274, in *Österreichische Steuerzeitung* 12 (2008), p. 270, and in *Steuer- und Wirtschaftskartei* 19 (2008), p. S 528.

57. See Hans van den Hurk, Anno Rainer, Jan Roels, Otmar Thoennes, Eric Tomsett and Gerben Weening, "ECJ Rules on UK Corporate Taxation of Foreign Source Dividends", *Intertax* 2 (2007), p. 139.

58. After all, the tax rate on the receiving company under an exemption system always has to be zero, while, under a credit system, the normal tax rate applies and the actual tax burden in the state of residence depends on the tax imposed in the source state.

59. *FII Group Litigation*, note 14, Para. 56.

60. See Christian Massoner and Birgit Stürzlinger, note 2, p. 407.

61. See note 56.

62. See, however, note 65.

63. See Christian Massoner, note 2, p. 574.

64. See note 56.

65. In order to benefit from the tax credit, the taxpayer is required to provide the tax authorities with detailed information that includes the exact name of the distributing company, the amount of the holding and the corporate tax rate applicable to the distributing company. As mentioned above, if there is no such "special" treatment (such as personal exemptions or far-reaching objective exemptions) with regard to the corporate tax of the company, a simplified method of calculating the foreign tax will apply, which does not require verification of the actual tax burden; rather, a calculation of the virtual tax burden on the basis of the nominal standard corporate tax rate is sufficient.

66. See Zorn, "VwGH: Auslandsdividenden und Gemeinschaftsrecht", note 2, p. 425.

67. See Thomas Kühbacher, "Erfordert § 10 Abs 2 KStG bei ausländischen Portfoliobeteiligungen einen Anrechnungsvortrag?", note 2, p. 387 et seq. This issue arises because in a domestic setting a tax-exempt dividend would not decrease the loss carry-forward, whereas foreign-source taxable dividends decrease losses and to the same extent limit the potential to shelter future income; if no credit carry-forward were granted, such future income would then be fully taxable without the benefit of an offsetting foreign tax credit, even though it economically corresponds with the initial income inclusion of the foreign-source dividends.

sions. It nevertheless overburdens the Austrian system with the typical problems of a credit method, especially in regard to gathering information,⁶⁸ and does not pay due regard to the fact that Austria's tax system is traditionally based on the exemption method and only has rudimentary rules on foreign tax credits.⁶⁹ Furthermore, it is questionable whether or not (1) the conclusion reached by the VwGH correctly applies the principle of "suppression" under EC law,⁷⁰ and (2) the presumption of a certain policy preference of the Austrian tax system is indeed justified, as the Austrian legislator has frequently shown its preference for the exemption method,⁷¹ reserving the application of the credit method for special cases of abusive tax arrangements.⁷² In the end, therefore, the VwGH acted as a policymaker and it remains to be seen whether or not the legislator will follow the same considerations or decide in favour of another, EC-compatible method of providing for relief from economic double taxation with respect to foreign-source dividends.

3.2. Implications for dividends received from third countries

The Supreme Administrative Court refrained from ruling on the third-country dimension of the case and left this issue to be decided by the lower court. Indeed, the free movement of capital under Art. 56 of the EC Treaty also covers the movement of capital "between Member States and third countries". It was only recently that the ECJ started to chart the unknown waters of third-country relationships in the direct tax area.⁷³ While the ECJ obviously accepted the notion that taxpayers may, in principle, directly rely on Art. 56 of the EC Treaty in third-country situations, when application of this freedom is not pre-empted by another freedom and the resulting restriction is not grandfathered by Art. 57(1) of the EC Treaty,⁷⁴ the Court has yet to explore and delimit the meaning of Art. 56 of the EC Treaty in third-country relations by defining the standard of comparability, the acceptable justifications and the related proportionality standards.⁷⁵

One might nevertheless conclude that the impact of Art. 56 of the EC Treaty on Austria's participation exemption regime is fairly limited. In that respect, it should be mentioned that the ECJ has chosen to limit the scope of Art. 56 of the EC Treaty by simply denying the application of the free movement of capital in situations "primarily" affecting another fundamental freedom, since, in these cases, restrictions of the free movement of capital are "an unavoidable consequence" of any restriction on the other fundamental freedom and "do not justify, in any event, an independent examination of that legislation" in light of Art. 56 of the EC Treaty.⁷⁶ Only when the restriction of the free movement of capital is not an "unavoidable consequence" of the restriction of another fundamental freedom, can the taxpayer rely on Art. 56 of the EC Treaty.⁷⁷ While some legal scholars have argued that, in assessing which fundamental freedom is primarily affected, the specific factual situation of the taxpayer should not be relied on, but rather the scope of the

domestic measure,⁷⁸ the ECJ has recently supported the VwGH's approach⁷⁹ that the specific factual situation of the taxpayer is decisive.⁸⁰ Hence, even if the taxpayer meets the participation threshold by holding a controlling interest, say 25%,⁸¹ but sells the shares within the minimum holding period and may not, therefore, benefit from the exemption under Sec. 10(2) of the KStG, reliance on Art. 56 of the EC Treaty is pre-empted by the freedom of establishment. Even if the specific holding is below this threshold, however, Austria's law might be protected if the holding constitutes a "direct investment", which might be the case with regards to a shareholding of 10%.⁸² In such a situation, third country restrictions that existed as of the end of 1993 are grandfathered by

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68. In practice, it can be very difficult – if not impossible – for the taxpayer to provide all required information, especially in cases involving investment funds (see Gernot Aigner and Babette Prechtl, "Ermittlung der anrechenbaren ausländischen Körperschaftsteuer bei Portfoliodividenden", *Steuer- und Wirtschaftskartei* (2008) [forthcoming]). Indeed, a fund investor typically does not receive the required information to match dividends to certain shares, as the fund's tax calculations generally report dividends only by country (because of withholding taxes) and not by company, which makes it virtually impossible to verify the tax burden on a given dividend channelled through an investment fund.

69. It is, for example, unclear whether lower-tier taxes may also be credited, whether a credit carry forward is allowable, which year's tax burden is relevant if the distribution reflects profits from several taxable periods, etc. The Ministry's information (see note 56) has addressed some of these issues, but it remains to be seen how this approach works in practice, especially when it comes to a foreign "special" treatment (see note 65).

70. In the discussions surrounding the discriminatory effects of a flat withholding taxation of non-resident taxpayers' gross income many have argued that a taxpayer is indeed entitled to be taxed only on his *net* income at the – generally – low rate foreseen in domestic law, even if the overall result would be more beneficial than the taxation of a comparable resident taxpayer. The ECJ seemed to have accepted such a "cherry picking" approach in *Gerritse* (ECJ, 12 June 2003, Case C-234/01, *Gerritse*) by endorsing the Commission's calculations; it would then be for the domestic legislator to adjust the rate. See, for this discussion, Georg Kofler, "Scorpio: 'Ausländersteuer' und Gemeinschaftsrecht", *Österreichische Steuerzeitung* 4 (2007), p. 85 et seq.

71. See, in this regard, Christian Massoner and Birgit Stürzlinger, note 2, p. 400, at p. 403 et seq. and Reinhold Beiser, note 2, p. S 511 et seq.

72. For Sec. 10(4) of the KStG, see 3.3.

73. See, for example, *FII Group Litigation*, note 14; ECJ, 10 May 2007, Case C-492/04, *Lasertec*; ECJ, 10 May 2007, Case C-102/05, *A and B*; ECJ, 24 May 2007, Case C-157/05, *Winfried L. Holböck v. Finanzamt Salzburg-Land*; ECJ, 6 November 2007, Case C-415/06, *Stahlwerk Ergste Westig GmbH*; and ECJ, 18 December 2007, Case C-101/05, *A*.

74. *Holböck*, note 73, Para. 24 and Para. 30 et seq.; see also *FII Group Litigation*, note 14, Para. 169 et seq. and Para. 174 et seq.

75. For a recent discussion of the approaches in legal writing, see Axel Cordewener, Georg Kofler and Clemens Ph. Schindler, "Free Movement of Capital, Third Country Relationships and National Tax Law: An Emerging Issue before the ECJ", *European Taxation* 8/9 (2007), p. 107 et seq. and Axel Cordewener, Georg Kofler and Clemens Ph. Schindler, "Free Movement of Capital and Third Countries: Exploring the Outer Boundaries with *Lasertec, A and B* and *Holböck*", *European Taxation* 8/9 (2007), p. 371 et seq.

76. This line of reasoning had already been carefully laid out (although in a mere "EU situation") in *Cadbury Schweppes*, note 16, Para. 33. For the reverse situation, in which the freedom of capital was primarily applied in a non-tax case, see, for example, *Commission v. The Netherlands*, note 17 ("golden shares"). See also Tom O'Shea, "Third Country Denied Freedom of Establishment Rights in *Lasertec*", *46 Tax Notes International* (4 June 2007), p. 992.

77. *Holböck*, note 73, Para. 24.

78. See, for example, Axel Cordewener, Georg Kofler and Clemens Ph. Schindler, "Free Movement of Capital, Third Country Relationships and National Tax Law: An Emerging Issue before the ECJ", note 75, p. 112 et seq.

79. See 2.3.2.

80. *Burda*, note 19, Para. 71 et seq.

81. *Lasertec*, note 73, Para. 21.

82. In regards to this 10% threshold see UFS Wien, 14 December 2007, RV/0303-W/03, and the information issued by the Ministry of Finance in EAS 2880, reprinted in *Steuer & Wirtschaft International* (2007), p. 442.

Art. 57 of the EC Treaty. While the 10% minimum holding threshold seems to be grandfathered as an "existing" provision, it is at least doubtful that the minimum holding period of one year is also grandfathered.⁸³

Portfolio investments of less than 10%, however, are arguably not within the scope of the freedom of establishment or the grandfather clause of Art. 57 of the EC Treaty. A fortiori, the free movement of capital seems to be the freedom primarily affected in such situations. Nevertheless, the ECJ has already found that Member States may enjoy more leeway in justifying restrictive measures in third-country situations than they do within the European Union. Although the VwGH's decision is silent on whether or not the solution found for the intra-EU situation (i.e. the application of the indirect tax credit method) likewise applies to dividends received from third countries, it hinted towards the ECJ's decision in *A*,⁸⁴ wherein the Court accepted that the lack of proper information exchange may justify restrictions in a third-country setting. In obvious reliance on this judgment, the Austrian Ministry of Finance does not feel the need to extend the credit method to third countries,⁸⁵ an approach heavily criticized in the tax literature.⁸⁶ It remains to be seen, therefore, how the Austrian legislator will react to the new situation and whether or not it will differentiate between third-country scenarios and intra-EU scenarios.⁸⁷

3.3. The Austrian switchover clause

Finally, the VwGH's holding, read in light of the ECJ's decisions in *FII Group Litigation*⁸⁸ and *Columbus Container Services*,⁸⁹ implies that Austria's anti-avoidance provision concerning the international participation exemption in Sec. 10(4) of the KStG, which foresees a switchover from the exemption to the indirect credit system if the foreign distributing company derives mainly passive income and is subject to low taxation in its country of residence,⁹⁰ is in accordance with EC law.⁹¹ This result can be implied based on a twofold argument. First, in light of *FII Group Litigation*, a vertical comparison between distributions of a domestic subsidiary and distributions of a foreign subsidiary reveals that EC law permits the application of the credit method only to the latter. Second, *Columbus Container Services* demonstrates that one cannot establish discrimination by way of a horizontal comparison of distributions by two foreign subsidiaries, one being resident in a high-tax jurisdiction and, therefore, not subject to the switchover, the other being resident in a low-tax jurisdiction. Read together, therefore, these decisions seem to permit a switchover as long as the credit method does not lead to a discriminatory result.⁹²

4. Conclusions

In its landmark decision of 17 April 2008 the Austrian Supreme Administrative Court sided with the lower court and tax literature finding that the Austrian participation exemption regime, pursuant to which dividends received by a company resident in Austria from a domestic company are tax exempt, while dividends from a foreign company are only exempt if a minimum holding requirement and holding period are met, infringes on the free movement of capital. The VwGH, however, has determined that the legal ramifications of such infringement do not necessitate extending the exemption to foreign-source dividends from EU companies, but rather that an indirect tax credit for the tax underlying such distributions suffices to cure the breach of EC law. This result comes as a surprise and imposes a series of problems on the traditionally exemption-oriented Austrian tax system, including questions regarding the gathering of necessary information, the determination of the creditable amount, the ability to carry such credit forward, etc. Also, the impact of this judgment on third-country investments remains to be clarified.

83. See Georg Kofler and Gerald Toifl, note 1, p. 241.

84. *A*, note 73, Para. 60 et seq.

85. With the exception of dividends received from companies resident in Norway, the only EEA country with which Austria has a tax treaty that also provides for mutual assistance in regards to the recovery of tax claims.

86. See, for example, Ernst Marschner, note 2, p. 265; Markus Christoph Stefaner, note 2, p. 166; and Christian Massoner and Birgit Stürzlinger, note 2, p. 408 et seq.

87. Among the third country scenarios the legislator could further differentiate between shareholdings that are "direct investments" (and provisions of the law are grandfathered according to Art. 57 of the EC Treaty) and those that do not constitute "direct investments". In the latter situation, the taxpayer may have full recourse to Art. 56 of the EC Treaty. Given the increased justification leeway, however, it is unlikely that the case law of the ECJ on intra-Community dividend treatment will be directly transposed to third-country scenarios.

88. *FII Group Litigation*, note 14.

89. *Columbus Container Services*, note 38.

90. This provision is designed to prevent resident companies from benefiting from the international participation exemption if the focus of the non-resident subsidiary's business operations consists directly or indirectly in deriving interest income, income from the leasing of assets or the sale of participations ("passive income") and has been subject to low taxation, i.e. a foreign tax burden of less than 15%. In compliance with the EU Code of Conduct, from 1 January 2004 it is no longer relevant whether or not the resident parent company is predominantly directly or indirectly controlled by individuals resident in Austria.

91. See, for example, Nikolaus Zorn, "EG-Grundfreiheiten und dritte Länder", in Peter Quantschnigg, Werner Wiesner and Gunter Mayr (eds.), *Steuern im Gemeinschaftsrecht*, Festschrift für Wolfgang Nolz (Vienna: LexisNexis, 2008), p. 235 et seq.; Ernst Marschner, "Rechtsprechung des EuGH zu „Inbound“- und „Outbound“-Dividenden und seine Auswirkungen auf Österreich", *Finanzjournal* 3 (2007), p. 89; Thomas Kühbacher, "Der Methodenwechsel des § 10 Abs 4 KStG im Licht des Gemeinschaftsrechts", *Österreichische Steuerzeitung* 5 (2008), p. 92 et seq.; Nikolaus Zorn, "Dividenden aus Auslandsbeteiligungen von Körperschaften", note 3, p. 5 471 et seq.; Nikolaus Zorn, "VwGH: Auslandsdividenden und Gemeinschaftsrecht", note 3, p. 425; and Thomas Bieber and Georg Kofler, "Der Methodenwechsel nach § 10 Abs 4 KStG", in Friedrich Fraberger, Andreas Baumann, Christoph Plott and Kornelia Waitz-Ramsauer (eds.), *Handbuch Konzernsteuerrecht* (Vienna: LexisNexis, 2008), p. 193 et seq.

92. See, for this analysis, 3.1.