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News Analysis: Belgium Can Disregard French Withholding Tax on Dividends, ECJ Advocate General Says

by Georg W. Kofler and Clemens Philipp Schindler

Kerckhaert-Morres (C-513/04) is one of several cases on dividend taxation pending before the European Court of Justice. As far back as 1992, the Ruding Report ("Report of the Committee of Independent Experts on Company Taxation," Commission of the European Communities) said that "the manner in which Member States currently provide relief for the double taxation of cross border dividend payments to individual investors constitutes a source of discrimination against cross border investment flows," and concluded that "such discrimination tends to fragment capital markets in the Community."

Although the receipt of dividends is not expressly mentioned in the (nonexhaustive) nomenclature in Annex I of Council Directive 88/361/EEC on capital movements, previous case law shows that cross-border dividends constitute a capital movement covered by the EC Treaty's principle of free movement of capital, which is also the freedom relied on in *Kerckhaert-Morres*. In contrast to all the other fundamental freedoms established in the EC Treaty, the free movement of capital, by its broad wording, also applies in the context of third (non-EU) countries, although there is a lot of controversy regarding the specific details. However, if the shareholder has a definite influence over the dividend-paying entity's decisions and is able to determine its activities, the principle of freedom of establishment would grant additional protection to the shareholder.

In *Kerckhaert-Morres*, the question submitted to the ECJ by the Belgian Rechtbank van Eerste Aanleg te Gent is: "Must Article 56(1) EC . . . be interpreted as prohibiting a restriction resulting from a provision in the income tax legislation of a Member State . . . which subjects dividends from resident companies and dividends from companies resident in another Member State to the same uniform tax rate, without in the latter case providing for the imputation of tax levied at source in that other Member State?"

In the case at issue, a married couple, Mr. Kerckhaert and Mrs. Morres, both Belgian taxpayers, received dividends in 1995 and 1996 from a company resident in France. At that time, France operated an imputation system under which the corporate tax at the company level was fully or partially imputed onto the income tax due on the dividends at the shareholder level.[1] The system granted an imputation credit (*avoir fiscal*) to domestic shareholders and, if so provided in a tax treaty, to foreign shareholders as well.

In that case, the credit was considered a dividend and therefore was subject to French withholding tax. Also, the taxpayer had to declare that amount in his personal income tax return in his country of residence. Article 15(3) of the Belgium-France tax treaty, as applicable in *Kerckhaert-Morres*, provides that dividends paid by a company resident in France would entitle Belgian individuals to an imputation tax credit if French residents would have a right to that tax credit. That applies after a deduction of withholding tax calculated at a rate of 15 percent on the gross dividend, consisting of the amount of the distributed dividend increased by the tax credit.

[1]In contrast, under Belgium's schedular system, a company's profits are subject to corporate tax, while dividends are taxed as a separate, preferentially taxed category of income.

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On taxation in Belgium, that withholding tax, however, was not credited to the tax due,[2] but rather, was deducted from the tax basis.

Although domestic and cross-border dividends were both subject to a 25 percent tax rate and thus seemed to be treated equally, the inability to obtain credit for the foreign tax led to a higher tax burden in the cross-border scenario. Advocate General Leendert A. Geelhoed thus analyzed "whether the Belgian legislation amounts to indirect discrimination — that is, despite being equally applicable in law to foreign-source dividends, it has a discriminatory effect in fact."

Example 1

	Belgian Dividend	French Dividend
Gross Dividend	1,000	1,000
(Reduced) French Withholding Tax		(150)
= Income Tax Basis in Belgium	1,000	850
- Income Tax (25%)	(250)	(212.50)
+ Credit of French Withholding Tax		
= Tax Burden in Belgium	250	212.50
= Total Tax Burden	250	362.50
= Net Dividend	750	637.50

Commentators, however, noted that because of the grant of an imputation credit to shareholders, Kerckhaert and Morres were in fact better off than if they had received the dividend from a company resident in Belgium. Following that line of reasoning, the AG concluded that "the actual effect of the operation of the French system was that Belgian-resident shareholders received a higher amount in the case of French-source dividends than in the case of exactly the same amount of dividends distributed from a Belgian company." He illustrated that in Example 2 below, which originally was presented by the Belgian government.

The AG therefore found that "Belgian residents receiving French-source dividends are not worse off

Example 2

	Belgian Dividend	French Dividend
Gross Dividend	1,000	1,000
Avoir Fiscal (50%)		500
(Reduced) French Withholding Tax		(225)
= Income Tax Basis in Belgium	1,000	1,275
- Income Tax (25%)	(250)	(318.75)
= Net Dividend After Tax	750	956.25

in comparison to those receiving Belgian-source dividends; on the contrary, the combined effect of the French and Belgian tax systems means that overall they are better off." Accordingly, he found that there is no discrimination or restriction within the meaning of article 56 of the EC Treaty. He also highlighted the inherent risk "when examining the situation of an individual economic operator in the framework of just one State's legislation, or just one facet of this legislation."

The AG's opinion therefore focused on the actual effect of the Belgian rules. Nevertheless, he modified his analysis by assuming — all other things being equal — that no French tax credit (avoir fiscal) is granted to the Belgian shareholders. Despite the fact that in such a case the overall tax burden would have been higher in the cross-border context (see Example 1), he concluded that "[s]uch a potential disadvantage for Belgian residents receiving French dividends would not . . . result from any breach of the Treaty," and that "the free movement provisions of the Treaty do not as such oblige home states to relieve juridical double taxation resulting from the dislocation of tax base between two Member States."

As in his opinion in *Test Claimants in Class IV of the ACT Group Litigation* (C-374/04) (see *2006 WTD 37-5* or *Doc 2006-3577*), Geelhoed argued that "the possibility of juridical double taxation, in the absence of priority rules between the relevant States, is an inevitable consequence of the generally accepted method under international tax law of dividing tax jurisdiction between States" and that "[u]nder Community law, the power to choose criteria of, and allocate, tax jurisdiction lies purely with Member States." He based that line of reasoning on the ECJ's decision in *Gilly* (C-336/96) (see *98 TNI 173-3* or *Doc 98-27473*).

According to Geelhoed, "the mere fact that a home state such as Belgium might not have chosen to relieve juridical double taxation on dividends would not in itself be contrary to Articles 43 or 56 EC, as

[2]The language of the applicable treaty (article 19A) in fact suggests that Belgium is obligated to grant a credit for the tax withheld. However, Belgian courts have found that provision to be redundant because the domestic credit to which the treaty refers has been abolished.

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long as that State complied with the obligation not to discriminate between foreign-source and domestic-source dividends in exercising its tax jurisdiction. . . . Any distortion of economic activity resulting from such a choice would result from the fact that different tax systems must, in the present state of development of Community law, exist side by side, which may mean disadvantages for economic actors in some cases, and advantages in other cases."

Before presenting his conclusion, the AG addressed the problem of how to avoid such juridical double taxation, and concluded that "causes and character of these quasi-restrictions mean that they may only be eliminated through the intervention of the Community legislator, in the absence of which intervention they should be held to fall outside the scope of the Treaty free movement provisions." Without entering into a detailed discussion, we submit that such argumentation is not entirely convincing. Most European scholars hold to the view that juridical double taxation constitutes a serious obstacle to cross-border economic activities, which an activity in a purely domestic context does not have to face. Therefore, it is commonly argued that taxpayers have the right under the fundamental freedoms to be relieved from such double taxation, although it would be for the ECJ to give guidelines as to which member state has to refrain from exercising its taxing rights in a specific case.

Based on his argumentation, the AG suggested that the ECJ should answer the question submitted for preliminary ruling as follows: "Article 56(1) EC does not prohibit a restriction resulting from a provision in the income tax legislation of a Member State, such as the Belgian legislation at issue in the present case, which subjects dividends from resident companies and dividends from companies resident in another Member State to the same uniform tax rate, without in the latter case providing for the imputation of tax levied at source in that other Member State." ◆

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