Reprinted from *Tax Notes Int'l*, February 28, 2005, p. 739

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NEWS ANALYSIS

ECJ to Examine Belgian Treatment of Inbound Dividends

by Marc Quaghebeur

The Ghent Court of First Instance has sought a preliminary decision from the European Court of Justice on whether Belgium's tax regime for inbound dividends is compatible with EU law.

Belgian Domestic Law

One of the basic principles of the Belgian income tax system is that a dividend received by a resident individual is subject to a 25 percent withholding tax. That withholding tax is the final tax for the taxpayer, meaning that he does not have to declare the dividend in his tax return.

However, if no tax has been withheld at source, either by the company distributing its profits or by the intermediary (usually a bank), the taxpayer must declare the dividend and pay income tax at a rate of 25 percent.

Belgium taxes inbound dividends the same way. However, under the provisions of Belgium's double tax treaties, the country where the dividend originates can withhold tax at source on the dividend before it is paid out. Belgium grants unilateral relief to prevent double taxation by applying the deduction method: The foreign tax credit (FTC) is deducted from the gross dividend before the Belgian tax is calculated. The Belgian 25 percent withholding tax (or, alternatively, the final income tax) is calculated on the net dividend after deduction of the foreign withholding tax. (See below.)

	Domestic Dividend	Inbound Dividend
Dividend	100	100
Foreign withholding tax: 15 percent		-15
Dividend after foreign withholding tax	100	85
Income tax: 25 percent	-25	-21.25
Net dividend	75	63.75

European Community Law

In its communication of December 19, 2003,[1] the European Commission examined the taxation of dividends received by individual shareholders who are portfolio investors. The commission based its study on the case law of the ECJ, particularly its decision in *Verkooijen* (C- 35/98). (For the ECJ judgment, see *2000 WTD 119-16* or *Doc 2000-16738*.) The goal of the communication is to provide guidance on

[1]Communication from the European Commission to the European Council, the European Parliament, and the European Economic and Social Committee on Dividend Taxation of Individuals in the Internal Market, COM(2003) 810 final.

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the implications of EU law for the dividend tax systems applied by the member states, and to help them ensure that their systems are compatible with the requirements of the internal market.

The basic principle derived from that case law is that without harmonization, direct taxation falls within the competence of the member states. Nonetheless, they must exercise that competence consistently with EU law.

For individual shareholders with shares in a foreign company, the provision concerning the right of establishment (article 43 of the EC Treaty) has no relevance, unless they have definite influence over the company's decisions and they cannot determine its activities. That is rarely the case.

The way the question was put to the ECJ will make it very difficult for the Court to give a straightforward answer.

That means that only the provisions of the EC Treaty on the free movement of capital can be invoked. Article 56 prohibits all restrictions on the movement of capital between member states, and between member states and third countries. For the definition of the concept of "capital movement," the ECJ looked into Annex I to Council Directive 88/361/EEC of June 24, 1988, for the implementation of article 67 of the (EEC) Treaty (now article 56 of the EC Treaty). That annex is a nonexhaustive list of operations that constitute capital movements within the meaning of article 1 of Council Directive 88/361/EEC.

The receipt of dividends is not expressly mentioned in the nomenclature annexed to Directive 88/361 as capital movements, but in its *Verkooijen* decision, the ECJ found two reasons to link the receipt of dividends to capital movements. First, the receipt of dividends necessarily presupposes that the beneficiary of the dividends has participated in new or existing undertakings referred to under heading I(2) of the nomenclature. And second, the receipt of dividends also may be linked to the acquisition by residents of foreign securities listed on a stock exchange.[2]

Consequently, the receipt of dividends is covered by article 56 of the EC Treaty, and a domestic provision of a member state may restrict the free movement of capital within the meaning of article 56 of the treaty if: the provision is likely to dissuade residents of a member state from investing their capital in companies established in other member states,[3] or the provision is likely to constitute an obstacle for companies established in other member states to raise capital in that member state.[4]

In *Verkooijen*, the issue was that the Netherlands, when taxing dividend income, exempted the first NLG 1,000 (pre-euro). However, the exemption applied only to domestic dividends and not to inbound dividends paid by overseas companies. The ECJ found that provision of Dutch tax law to be a restriction on capital movements. It came to the same conclusion in its decisions of July 15, 2004, and September 7, 2004.[5] The latter decision concerning a credit granted by Finland for dividends from domestic companies but not for inbound dividends.

In its communication of December 19, 2003, the commission examined many situations involving inbound and outbound dividends considering that analysis. In particular, it found that when a member state applies the deduction method to inbound dividends, it results in higher taxation on inbound dividends than if it applied the tax credit method. That constitutes a restriction of the free movement of capital for individual taxpayers investing in foreign shares.

However, the commission had to concede that the member state does not have a discriminatory tax system, as it subjects domestic and inbound dividends to the same tax regime. The restriction of the free movement of capital results from the foreign withholding tax.

Nonetheless, the commission found one situation in which that argument could not be accepted from a member state — namely, when a member state has signed a double tax treaty with another state, has given the other state the right to levy a withholding tax, and has undertaken to give a credit for the foreign withholding tax. Under those circumstances, it is not the source state that is restricting the free movement of capital, but the state of residence, as the tax treaty requires that it must provide the relief.

Catch-22

But that is a "Catch-22" situation. Most (if not all) double tax treaties provide that the source state can

[2]*Verkooijen*, paragraphs 27-30.

[3]*See* Case C-484/93 *Svensson and Gustavsson v. Ministre du Logement et de l'Urbanisme* [1995] ECR I-3955, paragraph 10; Case C-222/97 *Trummer and Mayer* [1999] ECR I- 1661, paragraph 26; and Case C-439/97 *Sandoz v. Finanzlandesdirektion für Wien, Niederösterreich und Burgenland* [1999] ECR I-7041, paragraph 19.

[4]*See Verkooijen*, paragraph 35.

[5]In its decisions in Case C-315/02 *Lenz v. Finanzlandesdiektion für Tirol* and Case C-319/02 *Manninen*, respectively.

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withhold tax at source on the dividend, and in the article of the double tax treaty dealing with the methods for eliminating double taxation (article 23 of the OECD model income tax treaty), the state of residence may or may not undertake to grant a credit.

If it does establish that the state of residence must provide relief, the taxpayer is entitled to credit the foreign withholding tax against his personal income tax liability. If his state of residence gives him the credit, he cannot claim a restriction of the free movement of capital. However, if article 23 does not provide that the state of residence must grant a tax credit, the major condition for the restriction of the free movement of capital does not apply.

In either case, there cannot be a restriction of the free movement of capital. However, if the tax treaty provides that the member state must provide a credit for the foreign withholding tax, but the taxpayer finds that his state of residence refuses the tax credit, the problem is with the application of the tax treaty; it is not an issue of restriction of the free movement of capital.

Ghent

In the case submitted to the Ghent Court of First Instance, a Belgian resident individual had received dividends from a French company. In accordance with article 15, paragraph 2 of the Belgium- France tax treaty of March 10, 1964, the French company withheld 15 percent of the dividends at source.

Article 19(a) of the tax treaty provides that for dividends received by a Belgian resident individual, the tax due on the dividend, net of the French withholding, will be reduced, on the one hand, by the withholding tax collected at the normal rate, and on the other hand, by the FTC that is deductible under the conditions established by the Belgian legislation. (And that credit cannot be less than 15 percent of the net dividend.)

Until 1988, the individual shareholder was entitled to an FTC that was calculated on the assumption that the tax collected at source was 15 percent, regardless of the level of tax withheld abroad. (For prior coverage, see *Tax Notes Int'l*, Sept. 1, 2003, p. 798.) That FTC was abolished by the law of December 7, 1988, for private individuals holding shares outside a professional activity.

Based on article 19(a) of the Belgium-France tax treaty, the taxpayer claimed a credit of 15 percent, but tax authorities denied the credit. In his appeal, the taxpayer claimed that the denial of the credit was contrary to the provisions of the double tax treaty, and of EU law, particularly the provisions concerning the free movement of capital.

The first argument is redundant. Case law does not support the taxpayer's claim in a situation in which the tax treaty refers to a redundant Belgian domestic rule granting a tax credit for overseas tax, particularly after decisions of the *Cour de Cassation*[6] (Belgium's Supreme Court) and the Antwerp Court of Appeal[7] that dealt, respectively, with Belgium's double tax treaties with the Netherlands and Germany. In both situations, the provision dealing with the methods for eliminating double taxation mentions that the FTC is granted under the Belgian conditions or in accordance with the Belgian rate. An interpretation of the tax treaty that takes account of the evolution of tax laws leads to the conclusion that the Belgian legislature reserves the right to adapt the FTC regime as it existed at the time of the signing of the tax treaty.

More importantly, the Ghent Court of Appeal came to the same conclusion for the French double tax treaty, even if that treaty provides for a minimum FTC of 15 percent. The Court found that the abolition of the FTC did have an effect at the level of the double tax treaty because the minimum credit of 15 percent can apply only insofar as the credit can be set off under the conditions established by Belgian law.[8]

Testing that provision in view of the free movement of capital is a new approach that was inspired by the communication of December 19, 2003. The taxpayer noted that while Belgian domestic and inbound dividends are subject to tax at the same rate, the inbound dividend has undergone withholding tax abroad that cannot be set off against the Belgian income tax. The tax burden on inbound dividends is therefore higher than on domestic dividends. That dissuades Belgian investors from investing in companies established in another member state, and it is an obstacle for foreign companies established in other member states to raise capital in Belgium.

The Ghent Court of First Instance has asked the ECJ for a preliminary decision on whether article 56 of the EC Treaty is compatible with a provision of the income tax legislation of a member state that applies the same income tax rate to domestic and overseas dividends, but does not allow the set-off of a tax credit for the tax withheld at source on the dividend in the other member state.

Comments

The question lacks the distinction put forward by the commission in its communication of December

[6]Cassation, June 16, 2000, *F.J.F.* 2000/213.

[7]Court of Appeal, Antwerp, March 17, 1998, *Fiscoloog*, 1998, no. 657, p. 9

[8]Ghent, June 24, 1999, *Fiscoloog Internationaal*, 1999, no. 190, p. 3.

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19, 2003. The commission had seen a potential restriction of the free movement of capital if two conditions were met. However, those conditions, as explained above, resulted in a Catch-22 situation, which meant that there could never be a restriction.

The way the question was put to the ECJ will make it very difficult for the Court to give a straightforward, positive answer. That would mean that to ensure the free movement of capital, a member state would have to introduce a tax credit to neutralize the effects of a foreign tax on inbound dividends.

For the ECJ to follow the reasoning of the taxpayer would be a major deviation of its case law, which holds that without harmonization, direct taxation falls within the competence of the member states. It would, in fact, constitute an important step toward the harmonization of the tax laws of the member states — and that probably is a step too far. ◆

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