Definitive Withholding Tax on German Dividends Received by Foreign Pension Fund Infringes EU Law

December 12, 2019

The European Court of Justice ruled (ECJ 13 November 2019 – C-641/17) that the definitive withholding tax levied on German dividends received by foreign pension funds infringes the principle of the free movement of capital (Article 63 of the Treaty on the Functioning of the European Union), provided that the foreign pension fund is in an objectively comparable situation as a domestic pension fund (Pensionsfonds). This is the case if a foreign pension fund allocates the received dividends either pursuant to the law in force in the state of residence or on a voluntary basis to its reserves for pension payment obligations.

In this **beinformed** we explain the background as well as the practical implications of the ruling and who may benefit therefrom.

Facts

The College Pension Plan of British Columbia, a Canadian trust, received dividends from German stock corporations. In all cases the shares held by the trust amounted to less than 1 percent of the capital of the German corporation. A withholding tax in the amount of 25 percent of the gross amounts had been levied on the dividends.

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The German tax law provides for a refund of 2/5 (i.e. 10 percent) of the withheld tax to corporations with limited tax liability. In addition, the treaty between Germany and Canada, similar to many other double tax treaties, limits the source country's taxation on dividends of portfolio investments to 15 percent. After having successfully applied for the corresponding refund of withholding taxes, the trust also sought the refund of the remaining amount of withholding taxes (i.e. 15 percent of the gross dividend). The local tax office refused to grant such refund as pursuant to Section 32(1) Number 2 of the German Corporate Income Tax Act the trust's withholding tax is definitive for non-residents. The Canadian trust then submitted an action to the Fiscal Court of Munich, which referred the question whether the definitive withholding tax levied on German dividends received by foreign pensions funds infringes the principle of the free movement of capital (Article 63 of the Treaty on the Functioning of the European Union) to the European Court of Justice (ECJ).

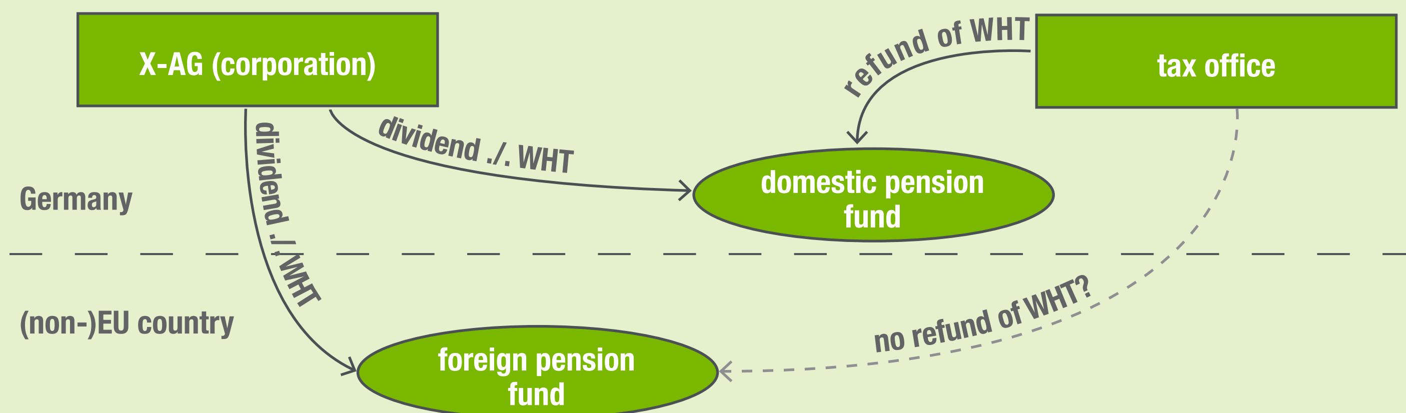
Background

According to the findings of the Fiscal Court of Munich in the request for a preliminary ruling by the ECJ (FG München 23 October 2017 – 7 K 1435/15), the College Pension Plan of British Columbia is comparable to a German pension fund (Pensionsfonds) within the meaning of Section 232 of the Act on the Supervision of Insurance Undertakings (Versicherungsaufsichtsgesetz).

If a German pension fund receives a dividend, an almost equivalent amount of such dividend is allocated to the premium reserve for pension payment obligations. Such allocation to the premium reserve causes a reduction of the taxable profit. Thus, the received dividend typically does not result in a taxable profit. In the course of the German pension fund's tax assessment, the tax withheld on the dividend is credited against the corporate income tax and thus practically fully refunded. In the end, this procedure results in an effect that is comparable to a tax exemption applicable only to domestic pension funds, but not to foreign pension funds.

On the basis thereof, the fiscal court held that the final withholding tax of 15 percent levied on the dividends received by the foreign pension fund constitutes an unequal treatment compared to the tax treatment of domestic pension funds and is therefore likely to constitute an infringement of the principle of free movement of capital and is neither justified by the principle of territoriality nor the need to ensure the cohesion of the German tax system, the effectiveness of fiscal supervision or any other recognizable reason.

Since, in the case at hand, a Canadian and thereby a non-EU pension fund is an affected party, the Fiscal Court of Munich raised the additional question whether the definitive withholding tax on German dividends is connected to financial services provided by the foreign pension fund. If so, the infringement of the principle of free movement of capital may be subject to the so-called standstill clause according to Article 64(1) of the Treaty on the Functioning of the European Union, as in principal the definitive withholding tax on dividends received by a foreign pension fund already existed before 1994. In such case, a pension fund situated in a non-EU country would not benefit from an preliminary ruling, even if the ECJ determines an infringement of the free movement of capital.



The European Court of Justice's Decision

As we expected (see **beinformed**, dated 13 February 2018), the ECJ shared the view of the Fiscal Court of Munich and affirmed that the unequal treatment causes an infringement of the principle of free movement of capital, which could not be justified by any recognizable reason, provided that the foreign pension fund is in an objectively comparable situation to that of a domestic pension fund. A foreign pension fund is in an objectively comparable situation if it allocates the dividends received either pursuant to the law in force in the state of residence or on a voluntary basis to its reserves for its future pension payment obligations. It is now for the referring Fiscal Court of Munich to assess whether this is the case with regard to the German dividends received by the College Pension Plan of British Columbia in this instance.

In addition, the ECJ ruled that the definitive withholding tax on German dividends is not subject to the standstill clause according Article 64(1) of the Treaty on the Functioning of the European Union.

The standstill clause allows EU member states to continue to apply vis-à-vis non-EU countries certain restrictions to the free movement of capital in principle if such restriction was already in force on 31 December 1993. The application of this standstill clause presupposes that the legal provisions relating to the restriction in question have formed part of the legal order of the Member State concerned continuously since such date. However, the ECJ did not decide if this temporal criterion is fulfilled. Instead, it is for the referring Fiscal Court of Munich to determine whether the situation of a foreign pension fund has become less advantageous than that of a domestic pension fund after 31 December 1993 as special legislation relating to pension funds was not introduced until 2002. However, the ECJ did conclude that the standstill clause does not apply either way as a sufficiently close causal link between the movement of capital and a provision of financial services within the meaning of Article 64(1) of the Treaty on the Functioning of the European Union by the foreign pension fund does not exist.

Practical Implications

Foreign pension funds – either situated in EU member states or in non-EU countries – should assess if they have been subject to German withholding tax on dividends and if they are in a comparable situation to that of a German pension fund by way of having allocated such dividends to its reserves for covering future pension payment obligations. It is still, however, for the national tax courts and the fiscal authorities to provide guidance on the required proof of such allocation.

Moreover, certain foreign insurance companies should benefit from the ECJ's ruling. With regard to insurance companies, the decisive factor will be if they receive German dividends as part of their life or health insurance business. The reason therefore is that German life and health insurance companies generally share the same tax situation as German pension funds as far as premium reserves are concerned.

It is not entirely clear which statute of limitation is applicable to the filing of a refund claim based on an infringement of EU-law. We assume, however, that most likely a four-year limitation period, beginning after the end of the calendar year in which the dividends were received, should apply. Refund claims for dividends received in 2015 should therefore be filed by 31 December 2019. Even if not all required proof of allocation (e.g. (sub-custodian) vouchers) is available on such short notice, filing a protective claim before the end of 2019 should be considered. The full supporting documentation and proof of allocation may than be provided thereafter.

in touch: Any questions? Please do not hesitate to contact us!

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