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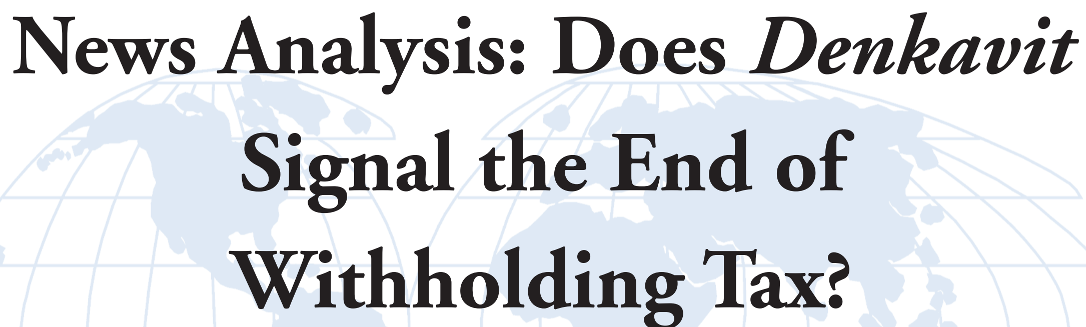

News Analysis: Does *Denkavit* Signal the End of Withholding Tax?

by Jérôme Delaurière

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News Analysis: Does *Denkavit* Signal the End of Withholding Tax?

by Jérôme Delaurière

The European Court of Justice on December 14, 2006, handed down a memorable decision in *Denkavit* (C-170/05) for French and European tax circles following a question posed by the French Conseil d'Etat. (For the judgment, see *2006 WTD 241-13 or Doc 2006-24958*.) As a result of the decision, the French government may have to reimburse tens of millions of euros of illegal withholding tax.[1]

Denkavit International BV, a Dutch company, had two French subsidiaries, one held at 99.9 percent and the other held directly at 50 percent and indirectly at 50 percent. From 1987 to 1989, the two subsidiaries paid out dividends to their parent company. Under the combined application of the French legislation in force at the time, and the France-Netherlands tax treaty signed March 17, 1973, the dividends were subject to a French withholding tax of 5 percent.

At the time, French law provided that the dividends paid out by a resident company to a nonresident individual or company are subject to a withholding tax of 25 percent. Moreover, the tax treaty provided that the dividends paid out by a company residing in one of the contracting states to a resident of another state were taxable in the other state but they may be subject to a withholding tax at a rate of 5 percent when the parent company held at least 25 percent in the subsidiary.

The Denkavit companies contested the payment of the 5 percent withholding tax on the basis that the internal legislation in question is contrary to article 43 EC. The Conseil d'Etat sent the question to the ECJ.

The Conseil d'Etat explained that the French tax deduction at source applies to nonresident parent companies to whom the dividends are paid, while a resident parent company may benefit from a near total exemption on those dividends. Taking into account (i) the lack of tax deduction at source between resident companies and (ii) the French participation exemption regime allowing for the exemption of dividends, dividends received by a French parent can be almost fully tax-exempt, with the exception of a 5 percent portion that is subject to corporate tax (unless the actual expenses are demonstrated to be lower or there is a French tax group, in which case the dividends can be fully exempt).

Consequently, the Conseil d'Etat asked the ECJ to determine if a provision that imposes the burden of taxation on a parent company in receipt of dividends that is not a resident of France, while relieving parent companies that are residents in France of a similar burden, is open to challenge in light of the principle of freedom of establishment.

The Conseil d'Etat also asked if the tax credit mechanism put in place by the tax treaty should be taken into account to assess the compatibility of the withholding tax system with the freedom of establishment and whether the tax treaty could be analyzed merely as a compatible means of apportioning the taxable item between the two states.

As analyzed below, the ECJ held that the French withholding tax applicable to outbound dividends is a discriminatory measure incompatible with the EC Treaty. Although constituting a new big bang in the field of French and EU taxation, there have been several recent precursors of the *Denkavit* decision. In any event, this decision will have a decisive impact in France and other member states with respect to withholding taxes, at least as far as dividends are concerned.

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[1]*Les Echos*, Dec. 21, 2006.

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Precursors of *Denkavit*

Before *Denkavit*, several recent decisions have been handed down by the ECJ, the Conseil d'Etat, and the European Free Trade Association (EFTA) court with respect to (i) discriminatory restrictions applied to dividends and (ii) the combination of national and conventional tax law with respect to those restrictions.

Discriminatory Restrictions

One of the decisions was *Lankhorst-Hohorst* (C-324/00), in which the ECJ held that the freedom of establishment principle conflicts with the German legislation concerning thin capitalization, which provides for the taxation of interest paid out by a resident subsidiary to a nonresident parent company at a rate of 30 percent (hidden dividends regime), even though, for interest paid out to a resident parent company, that interest is treated as a deductible expense. (For the judgment in *Lankhorst-Hohorst*, see *2002 WTD 241-23* or *Doc 2002-27361*.) The ECJ concluded that the difference in treatment resulted in a restriction on the freedom of establishment.

The Conseil d'Etat, influenced by *Lankhorst-Hohorst*, compared the situation of two French subsidiaries based on the residence or nonresidence of their parent company to analyze the French thin capitalization rules provided for in article 212 of the French Tax Code with respect to the freedom of establishment.[2] At the time, that article provided for restrictions on the deductibility of the interest on loans granted to French subsidiaries by nonresident parent companies, a restriction that did not apply to French parent companies or nonresident parent companies having a fixed place of business in France.

However, the reasoning of the ECJ in *Lankhorst-Hohorst* and the Conseil d'Etat in *Coréal Gestion* was not entirely transposable into *Denkavit*. In fact, in *Denkavit*, the question was not to compare the situation of a subsidiary based on the residence of its parent companies but to compare the situation of a resident parent company with that of a parent company residing in another EU member state, both companies having a resident subsidiary.

This is the outcome decided on by the EFTA court in *Fokus Bank* (E-1/04). In that case, dividends paid out by a company residing in Norway to shareholders residing in Norway were taxable as general income, whereas dividends paid out to nonresident shareholders were taxed at a rate of 15 percent. To avoid double taxation for the resident shareholders, those shareholders were granted a tax credit. In practice, dividends in the hands of residents were tax-free, whereas dividends paid to nonresidents were subject to a withholding tax in Norway.

The EFTA court held that article 40 EEA precludes legislation under which shareholders residing in a contracting state are granted a tax credit on dividends paid by a resident company, while nonresident shareholders are not granted a tax credit. In addition, the EFTA court refused to take into account the existence of a tax treaty to excuse the incompatibility of national legislation.

The *Fokus Bank* decision was partly inspired by the ECJ decisions in *Lenz* (C-315/02) and *Manninen* (C-319/02), which concerned inbound dividends in the context of the freedom of movement of capital. (For the judgment in *Lenz*, see *2004 WTD 138-7* or *Doc 2004-14606*; for the judgment in *Manninen*, see *2004 WTD 174-17* or *Doc 2004-17814*.) Since then, the ECJ has recently confirmed its *Lenz* and *Manninen* decisions in the context of inbound dividends in a U.K. context in *Test Claimants in the FII Group Litigation* (C-446/04). (For the judgment in *Test Claimants*, see *2006 WTD 239-10* or *Doc 2006-24779*.)

A decision from the Dutch Court of Appeal came to the same conclusion as the ECJ in *Denkavit*.[3] The appeals court held, as in *Denkavit*, that the Dutch withholding tax is an unjustifiable infringement on one of the fundamental freedoms enshrined in the EC Treaty. The tax in question was imposed only on the dividends paid to the offering shareholder. As in *Denkavit*, a credit against the withholding tax would be to no avail because the dividends were not taxable in Luxembourg.

EC Treaty and Tax Treaties

The response to the second question posed by the Conseil d'Etat in *Denkavit* was also present in the ECJ's judgment in *Bouanich* (C-265/04)[4] concerning the free circulation of capital. (For the judgment, see *2006 WTD 13-8* or *Doc 2006-1100*.)

The Swedish tax law establishes a distinction between resident and nonresident shareholders in the case of stock repurchases carried out by Swedish companies.

For resident shareholders, the repurchase is taxed as a capital gain on movable property at a rate of 30 percent, with the possibility of deducting the acquisition cost of the shares. For nonresident shareholders, the repurchase is taxed as a dividend payout also at a rate of 30 percent, subject to the

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[2] *Coreal Gestion*, Dec. 30, 2003, n°249047.

[3] *Amurta*, LJN:AU4025, Gerechtshof's-Hertogenbosch, 03/01980.

[4] "U.K. Tax Update: Mama Mia! U.K. Not Guilty (This Time)," *Tax Notes Int'l*, Aug. 22, 2005, p. 721.

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terms of tax treaties but without authorizing a deduction for the purchase price. In this case, the tax treaty with France (state of residence of the shareholder) provided for the application of a reduced rate of withholding at the source of 15 percent, which was substituted for the 30 percent rate.

For the ECJ, the refusal, for the repurchase of shares, to deduct the acquisition fees for nonresident shareholders constitutes an arbitrary restriction on the movement of capital as interpreted under article 56 EC insofar as this regulation places a heavier tax burden on nonresident shareholders than on resident shareholders in similar situations. However, the ECJ also recognizes that the elimination of double taxation is one of the goals of the European Community (article 293 EC). In the absence of Community harmonization measures to eliminate double taxation, the Court recognizes the power of the member states to determine the criteria for taxing income in view of eliminating double taxation and, through treaties if necessary, providing that the power is exercised in a nondiscriminatory manner.[5]

Insofar as Mrs. Bouanich had a tax rate of 15 percent set by the applicable tax treaty (as opposed to the 30 percent rate applied to residents), the ECJ delegated to the national jurisdiction the verification that the deduction of the nominal value and the application of a tax ceiling of 15 percent for nonresident shareholders results in a treatment that is not less favorable to that of residents who have the right to deduct the acquisition fees and to apply the 30 percent rate.

A case-by-case evaluation should therefore be necessary in this type of situation.

The *Denkavit* Decision

Despite the decisions mentioned above, the *Denkavit* case was the first time the ECJ took into account the tax treaty entered into between France and the Netherlands and analyzed the withholding tax regime of outbound dividends with respect to the freedom of establishment in order to (i) determine the existence of a discriminatory restriction and (ii) assess the compatibility of such a restriction with the EC Treaty.[6]

Discriminatory Restriction

In *Denkavit*, the ECJ first states that it has already held that, in tax law, the taxpayers' residence may constitute a factor that might justify national rules involving different treatment for resident and nonresident taxpayers.[7]

Thus, a different treatment cannot in itself be categorized as discrimination within the meaning of the EC Treaty, provided that there is a difference in objective such as to justify the difference in treatment.[8]

In addition, the ECJ admits that in the context of measures by a member state to prevent or mitigate the double taxation of profits distributed by a resident company, resident shareholders who receive dividends are not necessarily in a situation comparable to that of shareholders who receive dividends and are resident in another member state.[9]

However, the ECJ also states that when a member state imposes a charge to tax on the income not only of resident shareholders but also of nonresident shareholders, the situation of nonresident shareholders becomes comparable to that of resident shareholders.[10]

Accordingly, the ECJ rejects the French government's arguments that the situation of nonresident parent companies that do not have a fixed place of business in France is not comparable to that of nonresident parent companies that do have a fixed place of business in France. It also rejects the arguments that the exemption of dividends paid by resident subsidiaries to nonresident parent companies that do not have a fixed place of business in France would undermine the allocation of taxing powers between France and the Netherlands.

Because France, as the source state, has chosen to relieve economic double taxation domestically for its own residents, the ECJ simply but clearly considers this measure must be extended to nonresidents when (internal) economic double taxation is the result of France's tax jurisdiction. In other words, when the source state exercises its fiscal competence on income derived by nonresidents, the ECJ considers that it is not allowed under article 43 EC to discriminate between residents and nonresidents who are in a comparable situation.

In addition, justifications based on the territoriality principle and the claim that economic double taxation should be relieved by the residence state are rejected in this type of situation.

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[5] *Bouanich*, n°49; *see also Gilly*, May 12, 1998 (C-336-96), n°24 and 30.

[6] In the *Test Claimants in Class IV* (C-374/04) decision, the ECJ analyzed whether tax credits on outbound dividends were compatible with EC law but did not have to analyze withholding tax issues with respect to such dividends. (For the ECJ judgment, see *2006 WTD 239-9* or *Doc 2006-24778.*)

[7] *E.g., Marks & Spencer* (C-446/03). (For the ECJ judgment, see *2005 WTD 239-16* or *Doc 2005-25015*.)

[8] *See also Schumacker* (C-279/93), n°36 to 38; *Royal Bank of Scotland*, (C-311/97), n°27; *Test Claimants in Class IV*, n°46.

[9] *See also Test Claimants in Class IV*, n°57 to 65.

[10] *Id.*, n°68.

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Accordingly, the ECJ's answer to the first question is that articles 43 and 48 EC should be interpreted as precluding national legislation, which, in imposing a tax liability on dividends paid to a nonresident parent company and allowing resident parent companies almost full exemption from such tax, constitutes a discriminatory restriction on freedom of establishment.

It should be noted that as a result of the general wording of the ECJ decision, the author's views are that despite that *Denkavit* was rendered in the context of the freedom of establishment, the same reasoning should be applicable by the ECJ in the context of the free movement of capital.[11]

Treaty Doesn't Overcome Discrimination

As in *Bouanich* and contrary to the EFTA court in *Fokus Bank*, the ECJ examines whether the application of the tax treaty overcomes the effects of the restriction on freedom of establishment that was held to exist in the answer to the first question.

Dutch parent companies are exempt by the Netherlands from taxation on foreign-source dividends, with the practical result that no credit is given in respect to French withholding, despite the terms of the tax treaty, which authorize the Dutch parent company to offset the 5 percent withholding tax against its tax liability in the Netherlands. However, a parent company established in France is almost fully exempt from tax on those dividends provided it qualifies to benefit from the French parent-subsidiary regime.

Thus, the ECJ held that the combined application of the tax treaty and the relevant Dutch legislation does not serve to avoid the imposition of a series of charges to tax to which, unlike a resident parent company, a nonresident parent company is subject, and, accordingly, does not serve to overcome the effects of the restriction on freedom of establishment that was held to exist in the answer to the first question.

Accordingly, the ECJ's answer to the second question is that articles 43 and 48 EC should be interpreted as precluding national legislation that imposes, only with regard to nonresident parent companies, a withholding tax on dividends paid by resident subsidiaries. From the ECJ's point of view, the fact that this withholding tax is allowed under a tax treaty is not relevant if the nonresident parent company is unable to set off that tax in its member state in the manner provided for by that convention.

The Court goes further than in *Bouanich* insomuch as, in *Denkavit*, it directly determines, without referring issues to the national jurisdiction, that the restriction in the contested legislation may never be excused given the Dutch participation exemption that has to transform for effect the French withholding at the source into a final cost despite the tax credit provisions of the tax treaty, which aim to avoid double taxation situations.

[11]As this has been held under *Test Claimants in Class IV*, n°37 and 38.

Implications of *Denkavit* Decision

In practice, and given the general terms of *Denkavit*, the European countries that have a withholding tax regime for dividends or other income such as interest or royalties that discriminate against nonresident companies (or pension funds), and that have a national exemption regime with respect to such income, should rapidly bring their national legislation in line with this decision. Some of the possible effects of the *Denkavit* decision on the French withholding tax system on dividends and on other passive income are outlined below. There is also a brief discussion of the effects of the decision on residents in nonmember states.

French Withholding Tax System

Application of the 5 Percent Threshold

One direct effect of *Denkavit* is to allow parent companies that are resident in a member state and have a French subsidiary to claim the benefit of the existing 5 percent French participation exemption threshold to avoid any French withholding tax on dividends paid by their subsidiary (seeing as the *Denkavit* reasoning should be applicable in the context of the free movement of capital as indicated above).

Thus, despite the implementation of the parent-subsidiary directive, *Denkavit* should improve the tax regime of EU parent companies investing in France insofar as the thresholds provided by the directive are 15 percent in 2007 and 10 percent from 2009 — that is, higher than the 5 percent aforementioned threshold. Moreover, most of the tax treaties entered into by France do not fully relieve EU parent companies from French withholding tax, and they make the withholding tax exemption subject to a threshold that is usually higher than 5 percent.

It is too early to determine whether the positive consequences of *Denkavit* will remain fully in place in the long term from a French tax point of view. To comply with *Denkavit*, one option that the French legislator would have is to reduce the exemption threshold for the withholding tax to the 5 percent rate (*Denkavit* solution) or to align the national law threshold with the 10 percent rate provided by the parent-subsidiary directive as of January 1, 2009. While being detrimental to French parent companies owning more than 5 percent but less than 10 percent of the share capital of a subsidiary, the latter option would accelerate the application of the 10

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percent threshold provided under the parent-subsidiary directive to nonresident parent companies.

Another solution would be for the French Treasury to reimburse the amount of withholding tax when the nonresident can prove compliance with the conditions of the French participation exemption and the impossibility of applying the tax credit set out in a tax treaty in its state of residence.

Although this seems unlikely, the French legislator could also envisage extending the scope of the French withholding tax to domestic distributions and using an imputation system to eliminate double taxation, given that the U.K. rules on tax credits on outbound dividends has been held compatible by the ECJ.[12]

In any event, the member state companies who suffered French withholding tax while owning 5 percent of the share capital of a French company could file a claim to obtain the refund of the withholding tax levied on dividends that have been paid starting from January 1, 2003,[13] provided that the claim is filed before December 31, 2008.[14]

A similar consequence can be predicted in all member states having a national participation exemption regime using a lower threshold for resident companies compared with the threshold applicable to nonresident companies in accordance with the parent-subsidiary directive.

Potential Incompatibilities

Denkavit indirectly outlines the potential incompatibility of article 119 *ter* 3° of the French Tax Code with EC freedoms. These provisions preclude EU parent companies having a French subsidiary from benefiting from the withholding tax exemption provided in accordance with the parent-subsidiary directive if those parent companies are controlled by shareholders who are not residents of a member state. This presumption of abuse can be challenged if the company can demonstrate that the holding chain's main purpose is not to benefit from the withholding tax exemption on dividends.

This general presumption of abuse discriminates against member state parent companies that are controlled by non-EU resident investors, compared with those having EU resident investors. In light of *Denkavit*, there are doubts as to the compatibility of this discrimination with EC law. Indeed, such a provision is not specifically designed to exclude from a tax advantage purely artificial arrangements, but it is generally aimed at any situation in which a French subsidiary is held by an EU holding company controlled by non-EU shareholders. Thus, we are wondering if this presumption of abuse is compatible[15] with the ECJ decisions in *Lasteyrie du Saillant* (C-9/02) (for the ECJ judgment, see *2004 WTD 215-11* or *Doc 2004-21394*) and *Cadbury Schweppes* (C-196/04) (for the ECJ judgment, see *2006 WTD 177-8* or *Doc 2006-19082*).

Companies Not Relieved From Double Taxation

To conclude that the French withholding tax provision on dividends constitutes a discriminatory restriction on freedom of establishment, the ECJ notes in *Denkavit* that it is the combination of the fact that the national legislation imposes a liability to tax on dividends paid to a nonresident parent company (whereas it does not impose such liability if paid to a resident parent company) and allows resident parent companies almost full exemption from such tax, which creates an incompatible discrimination insofar as France only prevents double imposition in favor of its resident parent companies.

Accordingly, in situations in which a withholding tax would be imposed on dividends paid to nonresident companies, whereas resident companies would not suffer any withholding tax but would be subject to tax at the ordinary rate on such income (because they would not meet the 5 percent French parent subsidiary threshold), we doubt that such withholding tax would preclude the freedom of establishment (or the free movement of capital), as a French company should not be relieved from any double taxation in this type of situation (contrary to the *Denkavit* situation).

Dividends Paid to Individuals

As far as individuals are concerned, the opinion of Advocate General Leendert Geelhoed delivered in the context of *Kerckhaert-Morres* (C-513/04) is worth mentioning[16] in addition to *Denkavit*. (For the judgment in *Kerckhaert-Morres*, see *2006 WTD 220-10* or *Doc 2006-23075*.)

[12]*Test Claimants in Class IV*.

[13]Practicing attorneys generally take the position that the new three-year deadline can be considered in conformity with the EC Treaty given that the ECJ has already held that the former French provisions providing for a four-year deadline did not render, in practice, the exercise of the rights conferred by the Community judiciary impossible nor excessively difficult (*Roquette Frères* (C-88/99)).

[14]The general law limit for claims ends on December 31 of the second year following the date of the event motivating the claim — that is, in this case, December 31, 2008 (article R. 196-1c of the French LPF).

[15]Although article 1 of the directive allows the member states to adopt national or conventional legislation to prevent fraud and abuse, such a provision does not necessarily allow a member state to include such a general presumption of fraud in its national legislation.

[16]"News Analysis: How the ECJ Got Europe Into the Trouble It Is In," *Tax Notes Int'l*, Dec. 18, 2006, p. 909.

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In *Kerckhaert-Morres*, Belgian residents received dividends from a French company. As a result of the Belgium-France tax treaty, the residents were granted a French avoir fiscal equal to 50 percent of the dividends paid as compensation for the corporation tax paid by the French company, and the gross dividends were made subject to a 15 percent withholding tax in France. Under Belgian law, those dividends were taxed at a rate of 25 percent (same regime as for the dividends from Belgian resident companies without providing for the possibility of setting off tax levied by deduction at source in France).

The ECJ held that the freedom of movement of capital does not preclude legislation that 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 setting off of tax levied at source in that other member state. In particular, the ECJ noted that the Belgian tax legislation does not make any distinction between dividends from companies established in Belgium and dividends from companies established in another member state (under Belgian law both are taxed at an identical rate of 25 percent by way of income tax) and that the Belgian residents had been granted the French avoir fiscal.

Geelhoed indicated in his opinion that "had no French avoir fiscal been granted to Belgian residents, France would in any event be subject to the source state obligation to ensure that, insofar as double economic taxation on outgoing dividends resulted from the exercise of its tax jurisdiction, equivalent relief was granted to such dividends as would be granted to dividends paid to French residents." According to the advocate general, this follows from the principle that tax benefits granted by the source state to nonresidents should be equivalent to those granted to residents insofar as the source state otherwise exercises equivalent tax jurisdiction over both groups.

The French avoir fiscal has been replaced by a tax rebate of 40 percent for French individual shareholders. Its purpose is to reduce the double economic taxation that would result from the fact that a French company's profits are first subject to corporation tax and then to income tax upon distribution. However, dividends paid to nonresident individual shareholders are subject to a 25 percent withholding tax in France, this rate being generally reduced to 15 percent in accordance with the tax treaties entered into by France.

Seeing as that only French residents are exempt from French withholding tax and benefit from the 40 percent rebate, it could be sustained that France no longer grants an equivalent relief from double taxation to dividends paid to nonresidents as should be granted to dividends paid to French residents. Accordingly, based on the opinion of Geelhoed, there is a risk that the French withholding tax applied to dividends paid to nonresident individual shareholders could be viewed as a discrimination precluded by the freedom of movement of capital (in particular in situations in which no credit would be granted for such tax in the state of residence of the shareholder).

Dividends Paid by French REITs

The French Parliament has decided to levy a new 20 percent tax on distributions made by French real estate investment trusts (in France, SIICs) to tax-exempt investors owning at least 10 percent of their financial rights directly or indirectly.[17] In practice, this tax is due by the REIT itself. It aims to end a double-exemption situation that currently benefits some EU shareholders of a REIT.

The first exemption results from the normal application of the REIT tax regime under which the REIT's profits are tax-exempt if at least 85 percent (or 50 percent as the case may be) of such profits are distributed. The second exemption results from the domestic law of some EU states (mainly Spain) where some resident shareholders of such states may receive the REIT's dividends tax-free under some conditions. As a result of this double exemption, and seeing that France accepts applying the reduced withholding tax rate provided under the relevant tax treaty, some EU REIT shareholders are treated better than French residents. Indeed, REIT dividends received by French companies are fully liable to French corporation tax and cannot benefit from the French parent-subsidiary exemption.

In practice, seeing that the tax is due by the REIT itself, the cost of the tax will be shared between all the shareholders of the REIT and will reduce the REIT's distribution capacities. A better route for the French state would have been to renegotiate the relevant tax treaties (such as the France-Spain tax treaty). Because that option has not been chosen, it is therefore not possible for the French state to solve this double exemption by creating a withholding tax.[18] The French tax authorities have indicated that the creation of the 20 percent tax is justified by the coherence of the REIT tax regime and is an antiabuse provision: The French corporation tax exemption applied to the REIT is linked to the obligation of distribution of the REIT and the taxation of such dividends at the level of the investors.

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[17]Article 138 of the Amended Finance Law for 2006; FR 56/06; this tax applies to distributions made as of July 1, 2007.

[18]Although it could be discussed whether such a 20 percent tax is indeed a withholding tax, based on the ECJ's definition of withholding tax in the context of the parent-subsidiary directive (for example, *Athinaiki* (C-294/99)).

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It is difficult to consider that the double-exemption above can be abusive. This exemption resulted from the mere combined application of French law and the domestic law of the state of residence of the shareholder.

The coherence argument seems more relevant, insofar as the purpose of this tax is to end a reverse *Denkavit* situation in which French shareholders are treated worse than non-French shareholders. However, as indicated above, this tax will not end this reverse discrimination insofar as the cost of the tax will be shared between all the REIT shareholders, including the French-resident shareholders.

The creation of this tax raises the more general question as to how a member state can unilaterally end a tax advantage that benefits EU residents but has a detrimental effect on its own residents and that is not prohibited under other EU provisions.

Thus, according to Dorian Kelberg, spokesman for the Association of French SIICs, the question of the compatibility of this tax with EU and tax treaties will be discussed at the European and OECD levels.[19]

If these discussions are not successful, the French government will probably face challenges from EU investors on the compatibility of this tax based on EU law and the relevant tax treaty.

Other Consequences of *Denkavit*

Among other withholding taxes, French legislation retains tax at source on various passive income paid to nonresidents such as interest, royalties, and fees. However, our preliminary views are that *Denkavit* should not call into question withholding tax on these types of income insofar as they generally do not benefit from any tax exemption regime in France at the level of the beneficiary of such income, regardless of whether it is an individual or a company. The lack of exemption is due to the fact that there is usually no double taxation on such income because it creates a tax-deductible expense for the debtor, at least for corporation tax purposes.

In this respect, it is worth mentioning the *Scorpio* (C-290/04) decision under which the ECJ authorized a procedure of retention at source in the context of the freedom to provide services. (For the judgment, see *2006 WTD 192-10* or *Doc 2006-20584*.)

Under that decision, a German company organizing concerts paid fees to Europop for services provided in Germany to Scorpio. Europop was at that time established in the Netherlands and was not permanently or ordinarily resident or established in Germany. As a result of German tax law, Scorpio should have retained at source a 15 percent German withholding tax on the gross amount of the fee but did not. One of the questions asked by the German court of the ECJ was whether articles 59 and 60 EC must be interpreted as precluding national legislation under which a procedure of retention of tax at source is applied to payments made to providers of services not resident in the member state in which the services are provided, while payments made to providers of services resident in that member state are not subject to such a retention.

The ECJ held first that the German withholding tax regime "constitutes an obstacle to the freedom to provide services, prohibited in principle by Articles 59 and 60 EC." However, it acknowledged that "such legislation is nevertheless justified by the need to ensure the effective collection of income tax."[20] Accordingly, it held that the procedure of retention at source is a legitimate and appropriate means of ensuring the tax treatment of the income of a person established outside the state of taxation and ensuring that the income concerned does not escape taxation in the state of residence and the state where the services are provided.[21]

As far as France is concerned, this decision tends to confirm the compatibility of withholding tax national provisions (such as article 182 B of the French Tax Code) that are assessed on fees and royalties paid by resident companies to nonresident service providers,[22] provided that such taxes are retained on a net amount, as for resident service providers.

As far as withholding tax on interest is concerned, it seems that the reasoning of the ECJ in *Scorpio*, although it has been rendered in the context of the freedom to provide services, should be applicable in the context of the free movement of capital. More generally, it is only in specific situations that France

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[19]Juliette Rouillon, Reuters, Dec. 21, 2006.

[20]However, it should be noted that the ECJ outlined that at the material time, in 1993, no Community directive governed mutual administrative assistance concerning the recovery of tax debts between the Netherlands and Germany. Since then, Directive 2001/44/EC of June 15, 2001, and Directive 2002/94/EC of December 9, 2002, have amended and broadened the scope of Directive 76/308/EEC on mutual assistance for the recovery of claims relating to certain taxes.

[21]On the other hand and in accordance with *Gerritse* (C-234/01), the ECJ held that the freedom to provide services precludes national legislation under which the withholding tax is due on the gross amount of the fee without deduction for the business expenses reported by the nonresident service provider, whereas a resident provider of services is taxable only on his net income.

[22]When no EU intragroup exemption applies (such as article 182 B *bis* and 119 *quater* of the French Tax Code, implementing the directive dated June 3, 2003, on the payment of interest and royalties between EU companies) or when no tax treaty exemption applies.

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applies a withholding tax to interest paid to nonresidents because of its broad domestic exemption provided under article 131 *quater* of the French Tax Code.[23]

Impact for Non-EU Investors

An important question for the future will be to determine the impact of *Denkavit* on non-EU investors receiving dividends from France (as well as from other member states), where they are subject to French withholding tax but are exempt when paid to a resident of a member state under *Denkavit*. We do not purport to answer this complex question in this article, but we will outline two arguments that one can keep in mind concerning this issue: the free movement of capital and the tax treaty arguments.

Based on article 58 EC, the benefit of the free movement of capital can be applicable to non-EU resident situations. In this respect, there is the *Lasertec* (C-492/04) case pending before the ECJ regarding the application of the free movement of capital in tax law with respect to non-EU residents.[24] In *Lasertec*, which is a consequence of the *Lankhorst-Hohorst* decision, the ECJ will have to determine if the free movement of capital should be interpreted as meaning that the partial taxation as a distribution of profits of the payments of interest by a capital company resident in a member state to a parent company located in a third country is prohibited because this is an arbitrary discrimination, or if it should be interpreted as a disguised restriction on the free movement of capital between a member state and a third country.[25]

This case involves debt interest payments from a German subsidiary to a parent company domiciled in Switzerland. The payments were treated as nondeductible constructive dividends under Germany's old thin capitalization rules and, as a result, were subject to German tax at the level of the German subsidiary.

At this stage, we will simply say that it would seem to be a paradox for the ECJ to impose on the member states a duty to grant to third-country residents receiving EU dividends the same advantages that are granted to member state residents, while the third country would not have any reciprocal obligation. In our view, the purpose of the free movement of capital should be to protect the residents of the member states investing outside of the European Union from any discrimination, but it should not necessarily be to protect third-country residents investing in member states. The situation of the EU subsidiary of third-country residents (such as in *Lasertec*) seems more debatable.

The second argument is the potential application of the nondiscrimination provision of the tax treaties entered into by France with third countries. Indeed, *Denkavit* outlines that non-EU companies are discriminated against by France. Such discrimination results from France's refusal to allow non-EU companies to benefit from the 5 percent French participation exemption threshold while according such an advantage to French companies. It also results from the fact that, because of the *Denkavit* decision, France will now have to allow EU companies to benefit from the 5 percent threshold while non-EU companies are not entitled to benefit from this threshold.

Therefore, some of these investors could try to invoke the benefit of the nondiscrimination clauses when included in tax treaties between France and their state of residence to support that they have the right to benefit from the *Denkavit* reasoning. However, it should be noted that the French tax administration made a general comment to the OECD model (C(24) n°66), under which France applies the nondiscrimination principle only to individuals.

Nevertheless, France has sometimes entered into conventions of establishment (such as the France-U.S. convention dated November 25, 1959), which also includes nondiscrimination clauses applicable to legal entities under certain situations.

Thus, seeing as the tax regime of inbound and outbound dividends between member states has been clarified in most of its aspects, no doubt the next steps will be for the ECJ to examine the consequences of the above-mentioned decisions in the context of dividend distributions between member state and nonmember state companies. ◆

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[23]On the other hand, the European Commission formally requested on January 16, 2006, that Portugal amend its tax legislation on outbound interest payments. Under Portuguese law, interest paid to foreign banks may sometimes be taxed more heavily than interest paid to Portuguese banks, seeing as a 20 percent withholding tax is applicable to such interest and nonresidents are not allowed a deduction for the costs incurred in raising the capital lent (*Tax Notes Int'l*, Feb. 6, 2006, p. 445).

[24]There are also some pending affairs regarding inbound dividends (for example, *Holböck* (C-157/05); *Skatteverket* (C-101/05) and (C-102/05)).

[25] Subject to the standstill provisions of article 57 EC.