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European Court of Justice decides on withholding tax for German outbound dividends

On October 20, 2011, the Court of Justice of the European Union ("ECJ") decided that the German dividend taxation with respect to withholding taxes for non-resident companies is not in line with the free movement of capital (ECJ, Case C-284/09).

According to current German tax law dividend payments are subject to withholding tax of 26.375% irrespective of the recipient's place of residence. German resident companies who receive dividends and benefit from a participation exemption regime may be able to receive a full/partial refund of withholding tax. However, foreign resident recipients who do not benefit from the European Union ("EU") Parent-Subsidiary Directive can only get a partial reduction in withholding taxes according to domestic law or an underlying Double Tax Treaty (except in rare cases where the treaty provides for 0% withholding tax). The remaining withholding tax is final and could only be credited against the income tax in the state of residence.

In its decision, the ECJ held that this different treatment constitutes a restriction of the free movement of capital. The ECJ dismissed all of the government's arguments.

The government argued that the remaining withholding tax could be credited by the home state but the ECJ held that this would not fully neutralize the higher tax



burden. Furthermore, the ECJ dismissed the argument that any additional trade tax, which applies to resident shareholders but not to non-resident shareholders overcomes the discrimination on corporate income tax.

The ECJ decision affects portfolio shareholdings and shareholdings which do not benefit from the Parent-Subsidiary Directive held by EU or European Economic Area ("EEA") resident companies (e.g., due to non-compliance with the Directive's 12 month minimum holding period). Some questions remain, e.g. will this decision affect a company that cannot benefit from the Directive due to non-compliance with the German anti-treaty shopping rules. In addition, could third country investors (based on the infringement of the free movement of capital) benefit from the ECJ verdict?

The judgment implies that Germany is required to refund the withholding tax to foreign companies upon application. Therefore, foreign companies should consider applying for such refund within the statute of limitation. Companies should also consider the potential impact that not applying for a refund would have on their ability to claim a U.S. foreign tax credit for any withholding taxes paid. This concern could arise even for withholding taxes paid or accrued before the ECJ's decision.

Due to the impact that this decision may have on the German budget, the German government could take to offset the impact (e.g., by narrowing the scope of the participation exemption regime via excluding portfolio shareholdings).

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