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Editorial

Are we Heading towards an Internal Market without Dividend Withholding Tax but with Interest and Royalty Withholding Tax? Some Observations on Advocate General's Kokott Opinion in Truck Center

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In *Denkavit Internationaal* and *Amurta* the European Court of Justice (ECJ) decided that where the source State entirely eliminates double taxation on dividends distributed to domestic parent companies (amongst others by exempting the dividends from withholding tax), it cannot impose a withholding tax on dividends distributed to parent companies in other Member States. Resident and non-resident parent companies are as far as double taxation on dividends is concerned in an objectively similar situation because both receive dividends originating from profits that have already been taxed at the subsidiary's level. As the economic double taxation of dividends is caused by the source State levying corporate tax on the subsidiary's profits and withholding tax on the dividend distributed to the parent, it is for the source State to eliminate this discrimination. However, if a tax treaty between the source State and the parent's residence State provides that the latter will give a tax credit for the source State withholding tax, one must consider whether the treaty neutralizes the effects of the restriction of the treaty freedoms.[1] In view of these decisions the question arises whether a Member State violates the EC Treaty if it levies withholding tax on interest (or royalties) paid by a debtor established in that State to a beneficiary in another Member State, while it exempts such payments if made to domestic beneficiaries. This issue is at stake in the *Truck Center*-case (Belgian source interest paid to a Luxembourg corporate lender) and in the infringement procedure *Commission v. Portugal*, C-105/08 (Portuguese source mortgage interest paid to non-resident banks).

In the *Truck Center*-case Advocate General (AG) Kokott has delivered her opinion.[2] The AG distinguishes the *Truck Center*-case from *Denkavit Internationaal* and *Amurta* because of the different purposes of the withholding tax exemptions. In *Denkavit Internationaal* and *Amurta* the exemption of dividend withholding tax on domestic distributions aims at avoiding economic double taxation. Belgian corporate lenders are taxed on the interest payments but there is a deduction for the borrower. Hence, there is no economic double taxation. The aim of the withholding tax exemption on interest payments to Belgian corporate lenders is administrative simplification. Belgium does not charge withholding tax because the lender must prepay its corporate tax liability on the interest in quarterly instalments during the year the income is earned. It would be redundant and financially burdensome to subject the interest to withholding tax each time it is paid or accrued. The withholding tax assessed against non-resident corporate lenders, on the other hand, purports to ensure the effective collection of the Belgian tax liability which it has ascertained in Article 11 of the tax treaty with Luxembourg. According to the AG in the case at hand there is no discrimination between resident and non-resident lenders as they are not in an objectively comparable situation with respect to the collection and recovery of taxes in Belgium. Resident lenders report their income by filing tax returns, are subject to an ordinary assessment procedure and to direct control by the local tax authorities. This is not the case for non-resident lenders receiving interest in the source State. The collection and recovery of source State taxes require mutual assistance between the tax authorities. In *Scorpio* the ECJ has recognized that an efficient tax collection may justify that States apply different means to recover taxes depending upon whether the income is earned by residents or non-residents. To ensure an effective collection of taxes due by non-residents the source State may levy withholding tax, whereas it does not apply such tax where the income is earned by residents because such residents are subject to an ordinary assessment procedure.[3] I see no reason to disagree with AG Kokott.[4]

The AG goes on saying that by levying withholding tax against non-residents Belgium applies an appropriate and proportionate means to guarantee the effective collection of its tax claim. However, in *Scorpio* (§38) the ECJ seems to have accepted the different ways of collecting taxes from residents and non-residents because of the absence of mutual assistance for the recovery of tax claims between the Member States concerned. In the years under dispute Belgium could

1 ECJ, 14 Dec. 2006, C-170/05, *Denkavit Internationaal*; ECJ, 8 Nov. 2007, C-379/05, *Amurta*.

2 Opinion AG Kokott, 18 Sep. 2008, C-282/07, *Truck Center*.

3 ECJ, 3 Oct. 2006, *Scorpio*, C-290/04, §33-35.

4 However, the AG's approach is not the traditional way of considering the discrimination-issue. One would have expected the AG – in line with the ECJ's decision in *Bouanich* (also with the opinion of AG Kokott ECJ, 19 Jan. 2006, C-265/04) – to conclude that, where residents and non-residents are taxed on the same income in the source State, they are objectively comparable and that the more burdensome treatment of non-residents leads to indirect discrimination. Subsequently the justification is examined.

rely on the 1952 Benelux treaty on mutual assistance for the recovery of tax claims. AG Kokott concedes that such treaty could be a basis for Belgium to collect the Belgian tax against the Luxembourg lender by way of assessment, rather than by way of withholding. The Luxembourg company must then report its income in an annual tax return in Belgium. If it fails to pay the Belgian tax, Belgium could ask assistance from the Luxembourg authorities to enforce its tax claim against the Luxembourg company. The AG concludes that such a method is not necessarily a less proportionate means of collection of the Belgian tax as it leads to cumbersome and more costly procedures both for the taxpayer and the tax authorities. There is merit in this point of view. However, it is to my knowledge the first time that the burdens potentially imposed on the tax authorities are accepted for purposes of determining whether a tax rule is a proportional restriction. The ECJ traditionally rejects justifications based on administrative nuisance.[5] AG Kokott's position also seems to conflict with the ECJ's decision in *Turpeinen*. In his opinion to the *Turpeinen*-case AG Léger concluded that administrative difficulties imposed on the tax authorities cannot justify a discriminatory levy of withholding tax against non-residents. According to AG Léger the source State could subject non-residents to an ordinary assessment in the same way as it does with residents and recover its tax claim against the non-resident in that person's State of residence State under the EC recovery Directive.[6] The ECJ shared this view unconditionally. So, it remains to be seen whether the ECJ will follow AG Kokott's opinion in *Truck Center* and allow Belgium to levy withholding tax on interest paid to non-residents (and by extension on royalties as Belgium applies a similar rule) or whether it will, in line with *Scorpio,* require it to apply an ordinary assessment.

Regardless which way the ECJ will go, it will also have to address the issue of taxation by the source State of non-resident lenders on gross interest. In the years under dispute non-residents lenders were subject to 13,39% and 15% withholding tax in Belgium on gross interest, whereas resident lenders were subject to corporate tax at rates varying from 28% to 39% on net income. In, inter alia, *Gerritse* the ECJ decided that there is unjustified discrimination if non-residents are unable to deduct from the taxable income earned in the source State the expenses that are economically directly connected to the activity carried on in that State, where residents are able to claim such deduction, so that in the end non-residents are taxed more heavily.[7] AG Kokott distinguishes this case law from *Truck Center*. In her view in the cases decided by the ECJ the service provider was taxable on his entire income in the State where the service was performed and such income was tax exempt in his State of residence or qualified for a credit there. *Truck Center* on the other hand concerns a case of shared tax jurisdiction between two Member States. Belgium and Luxembourg agreed in the tax treaty that the interest is fully taxable in the residence State of the lender and the source State is only entitled to levy a withholding tax at a reduced rate. According to the AG it is obvious that the State of residence of the lender provides for the deduction of the expenses. She adds that there is no dispute on the deduction of the expenses and that intercompany loans do not involve significant expenses.

In the author's view reality is different though. Intragroup financing is often funded by loans as well. And what would be the position if the lender were not a group company but like in *Commission v. Portugal* a non-resident bank? Banks finance their activities essentially by client deposits and other third party funding. The AG's opinion also raises the question what the position would be where the interest is for whatever reason not deductible in the residence State or where the lender has suffered a loss in the residence State and has no immediate benefit from the interest deduction there. And finally and more importantly, the distinction between cases of shared tax jurisdiction and exclusive source State taxing seems to contradict the ECJ's decision in *Bouanich*. *Bouanich* concerns taxation of dividends in the source State and thus also a question of shared tax jurisdiction (Article 10 OECD MC). The ECJ decided that a non-resident should be able to deduct costs from the dividend subject to withholding tax to avoid discrimination with residents who could claim such a deduction. AG Kokott delivered the opinion in *Bouanich* and it was wholly in line with the ECJ's judgment.[8] There is no mention of the *Bouanich*-case in the part of the AG's opinion in *Truck Center* that deals with the question of taxation on gross or net interest. One wonders whether this is an oversight or whether it is intentional. Determining whether costs are directly related to the earning of interest is not a simple matter. It is submitted that a proportionate solution to avoid discriminatory taxation in the source State is for the source State to offer a non-resident lender the option to be taxed on net interest and thus to prove his directly related costs. Such an option may offer lenders who feel comfortable that they can meet this burden of proof a way to overcome the discrimination in the source State. Those who cannot prove their costs will suffer the discrimination but have the right to deduct the cost in their residence State. Of course, where deduction of the costs in the source State is claimed, the residence State is entitled to enact a measure preventing the deduction there.

5 E.g., ECJ, 4 Mar. 2004, *Commission v. France*, C-334/02, §31.
6 Opinion of AG Léger of 18 May 2006, *Turpeinen*, C-520/04, §80.
7 ECJ, 12 Jun. 2003, *Gerritse*, C-234/01, §27, ECJ, 6 Jul. 2006, *Conijn*, C-346/04, §26, ECJ, 3 Oct. 2006, *Scorpio,* C-290/04 and ECJ, 15 Feb. 2007, *Centro Equestre de Leziria Grande*, C-345/04, §24.
8 Compare ECJ, 19 Jan. 2006, *Bouanich*, C-265/04, §52-53 with the opinion of AG Kokott in *Bouanich*, §52-69.