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COMMUNICATION FROM THE COMMISSION TO THE COUNCIL, THE EUROPEAN PARLIAMENT AND THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE

Dividend taxation of individuals in the Internal Market

1. INTRODUCTION

In the Communication[1] accompanying the Company Taxation Study[2] the Commission proposed to develop guidance on important ECJ rulings and to co-ordinate their implementation via appropriate Communications from the Commission. The Communication specifically mentioned the *Verkooijen* ruling[3] on dividend taxation as important for the design of Member States' tax systems.

The Ruding report of 1992 had already highlighted that "the manner in which Member States currently provide relief for the double taxation of corporate profits distributed to individual shareholders in the form of dividends constitutes a source of discrimination against cross-border investment flows" and stated that "such discrimination tends to fragment capital markets in the Community"[4]. Elimination of this discrimination is essential to increase the competitiveness of EU financial markets and bring greater market liquidity, more rational allocation of capital, and greater choice for investors, all key objectives of the Financial Services Action Plan[5].

A better functioning single market for equity will also help to achieve the Lisbon goal of becoming "the most competitive and dynamic knowledge-based economy in the world by the end of the decade". Finally, it will help citizens to deal with the effects of demographic developments on pension provision, as the higher returns on such a market will help them to provide for their old age.

This Communication focuses on the taxation of the dividends received by individual shareholders who are portfolio investors, as this is the area that is most problematic in practice[6]. It provides guidance on the implications of Community law for Member States' dividend taxation systems, to help Member States to ensure that their systems are compatible with the requirements of the Internal Market. It also examines the economic effects of integration systems that are compatible with the Treaty principles regarding the free movement of capital.

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1 The Commission Company Tax Communication, COM(2001) 582 final, "Towards an internal market without tax obstacles".

2 SEC(2001) 1681, "Company taxation in the internal market", a Commission staff working paper released on 23 October 2001, available on the Commission's website under the address: http://europa.eu.int/comm/taxation_customs/publications/official_doc/sec/sec.htm

3 Case C-35/98 *Verkooijen* [2000] ECR I-4071.

4 Report of the Committee of Independent Experts on Company taxation (the Ruding Report), March 1992, pages 207-208.

5 COM(1999) 232 final of 11 May 1999.

6 Portfolio investors are investors who do not aim to influence the management of the target company. The taxation of dividends received by companies is to a large extent covered by the Parent-Subsidiary Directive (Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ L 225 of 20 August 1990), which provides for exemption of withholding taxes on the payment of qualifying dividends and credit or exemption in the hands of the company receiving them.

2. THE TAXATION OF DIVIDENDS IN THE INTERNAL MARKET

2.1. The taxation of dividends

2.1.1. General

Different levels of taxation should be distinguished, when considering the taxation of dividends. The first is the corporate taxation of the company's profits at the level of the company. The second is the taxation of the shareholder, subdivided in two parts:

a) Any withholding tax levied on the dividends paid by the company on behalf of the shareholder at the moment the dividends are paid out.

b) Income taxation at the level of the individual shareholder receiving the dividends.

2.1.2. Economic double taxation

Economic double taxation arises when the same income is taxed twice in the hands of two different taxpayers. In the case of dividends, economic double taxation may arise when first the company is subject to corporation tax and then the shareholder is subject to income tax on the distributed profits, i.e. the dividends.

2.1.3. International juridical double taxation

International juridical double taxation arises when two States tax the same taxpayer on the same income. In the case of dividends, international juridical double taxation may occur when the shareholder first suffers a withholding tax on his dividend in one State and then income tax in another State. Distributed profits of companies may suffer both economic and juridical double taxation.

Widely accepted guidelines for the elimination of international juridical double taxation of dividends are provided by the OECD Model Tax Convention on Income and Capital. According to Article 10 of the OECD Model Tax Convention dividends may be taxed in the state of residence of the shareholder, but also in the source state. However, the tax levied by the source state is limited to 15% if the shares are held by an individual shareholder. In their bilateral tax treaties Member States can agree to either levy lower source taxation or none at all (and outside the treaty context they can, of course, provide unilaterally for lower or no source taxation).

Articles 23 A and 23 B of the OECD Model deal with methods for elimination of double taxation. The combined effect of Articles 10 and 23 A and 23 B of the OECD Model is that in the case of individuals, the State of residence of the shareholder is allowed to tax dividends arising in the other State. However, it must credit against its own tax on such dividends the tax which has been collected by the State where the dividends arise[7]. No Member State has made a reservation on this part of the OECD Model.

[7] Paragraph 49 of the Commentary on Articles 23 A and 23 B of the OECD Model Tax Convention.

The credit under the OECD Model is only an ordinary credit, as opposed to a full credit. Ordinary credit means that the residence State limits the credit to its own tax on the dividend. So if the residence State does not tax the dividend, or taxes it at a lower rate than the source State, the OECD Model does not oblige the residence State to pay out the part of the foreign withholding tax in excess of the tax charged by the residence State itself.

Furthermore, Articles 10 and 23 A and 23 B of the OECD Model deal only with credits for tax levied directly on the dividend by the source state, i.e. the withholding tax paid by the company on behalf of the shareholder, and not with credits for the underlying tax, i.e. the corporation tax, as is the case in imputation systems[8].

Finally it should be noted that the credit system of the OECD Model applies regardless of the applicable dividend system (classical, schedular, imputation, exemption, see below).

2.2. Dividend taxation systems

All Member States' systems have in common that they levy corporation tax at the level of the company. Apart from variations in corporate tax bases and rates, they differ in their approach to the taxation of dividends received by individual shareholders. A basic choice each Member State had to make was whether or not to deal with the economic double taxation which may result from the combined effect of corporate and income taxation. Some Member States' systems may originally have been designed primarily for domestic situations. In practice Member States' systems may not fit into one of the four types described below, as they may combine elements of the various systems.

2.2.1. Classical system

The classical system sees the corporation as an entity entirely separate from its shareholders, consistent with its status as a separate legal entity. As a consequence, under the classical system the company’s profit is subject to corporation tax at the company level and the distributed profit, i.e. the dividend, is taxed at the shareholder level as part of his overall income at the applicable marginal income tax rate. The classical system thus results in full economic double taxation.

2.2.2. Schedular systems

Under schedular systems a company’s profits are equally subject to corporation tax, but dividends received by individual shareholders are taxed as a separate category of income. There are three subtypes of schedular systems.

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8 Paragraph 1 of the Commentary on Articles 23 A and 23 B.

Single schedular rate

Under this system the dividends received by individual portfolio investors are subject to a single separate tax rate. The schedular tax rate is usually in the range of 15 to 30%, i.e. considerably lower than the maximum marginal income tax rate, which is usually in the range of 40 to 60%. In practice the schedular tax rate is often chosen in such a way that the combined pressure of corporation tax and schedular tax corresponds to the top marginal income tax rate. Individual portfolio investors in the top income tax bracket thus never suffer more corporate and income tax on their dividends than the top marginal income tax rate. Another effect is that for a domestic entrepreneur with sufficient profits, the choice between self-employment and an incorporated business is tax-neutral (as is the case under the imputation system, see below). For taxpayers in the lower income tax brackets a system with a single schedular rate does not achieve complete neutrality, i.e. the combined pressure of corporation tax and schedular tax is higher than the tax they would have paid on the basis of the marginal income tax rate applicable to them. However, for most taxpayers the combined pressure is lower than under the classical system, and for shareholders in the high income tax bracket the system fully relieves double taxation.

Multiple schedular rates

Under this system a Member State has a separate schedular tax rate for each marginal income tax rate. With multiple schedular rates a Member State may achieve identical results as with an imputation system. The separate schedular rates can be chosen in such a way that for each income tax bracket the combined tax burden of corporation tax and income tax equals the marginal income tax rate, as under the imputation system. In practice, for countries with multiple marginal income tax rates the system could be simplified by applying only two schedular tax rates.

Half income tax method

Under the half income tax method only half of the dividends received by a shareholder are subject to the applicable marginal income tax rate. With the half income tax method the combined pressure of corporation and personal income tax on the dividend could also correspond to the top marginal income tax rate, i.e. this method could achieve the same result as the imputation system for high income taxpayers.

It would of course be possible to exempt more than half of the dividend for lower income taxpayers. In practice, however, the Member States which apply this system, have chosen the half income method (Germany, Luxembourg and Portugal; France has announced that it will introduce the half income method by 1 January 2005).

Right of assessment

Usually national rules provide for a right of assessment whereby low-income taxpayers may opt for the dividend to be taxed under the normal income tax rules, which amounts to application of the classical system, if that leads to lower taxation than applying the schedular system.

2.2.3. Imputation system

The imputation system is based on the conduit approach, where the corporation is viewed as a conduit, and the corporation tax on the company's profit serves as a prepayment for the income tax on the dividend of the shareholders. Under the imputation system both company and shareholder are taxed separately, but at the shareholder level the dividend is first grossed up by the corporation tax paid by the company on that income and then a credit is granted for some or all of that amount against the income tax on the dividend. Hence the credit may be 100% or lower. If the credit is equal to the corporation tax paid by the company on the dividend this system guarantees full relief of the economic double taxation for shareholders of all income levels.

2.2.4. Exemption system

Finally the dividend income may be exempt from income taxation.

2.3. The effects of the different systems

The following example illustrates the effect of the various methods in domestic situations, assuming a corporate tax rate of 33,3%, a marginal income tax rate of 50%, and, where applicable, a full imputation credit or a schedular tax rate of 25%. These rates are chosen in such a way that the effective tax rate on dividends, that is the combined pressure of corporation tax and income tax, equals the highest marginal income tax rate. In practice this is what many Member States have done, to achieve neutrality between self-employed and incorporated businesses.

To avoid any possible misunderstanding it should be underlined that the tax rates used in this example have no normative value, the only purpose of the example is to illustrate the different effects of the four systems.

Example 1: The effects of the various dividend taxation systems

		Classical	Schedular	Half income	Imputation	Exemption
1	Profit	100	100	100	100	100
2	Corporation tax 33,3%	33.3	33.3	33.3	33.3	33.3
3	Dividend (1-/-2)	66.7	66.7	66.7	66.7	66.7
4	Income tax base	66.7	66.7	33.35 (50% of 3)	100 (3+2)	0
5	Income tax (50% of 4)	33.35		16.7	50	
6	Full credit (2)				33.3	
7	Remaining income tax (5-/-6)				16.7	
8	Schedular tax (25% of 4)		16.7			

9	Net dividend (3-/-5, 7, or 8)	33.35	50	50	50	66.7
10	Effective tax rate on 1 is combined tax burden	66.65%	50%	50%	50%	33.3%

The classical system leads to unrelieved economic double taxation: The profit is first subjected to corporation tax at the level of the company and then after distribution to income tax at the level of the individual shareholder.

Schedular systems, including the half-income system, can be designed (as in the example) to give the same result in terms of the net dividend as the imputation system. In practice both systems can eliminate the economic double taxation, although the schedular systems achieve this without the extra calculations required by the imputation system[9]. Under both systems the effective tax (that is the corporation tax plus the applicable income tax together) on the dividend can be the same as the marginal income tax rate, at least for high income taxpayers. An effect of this is that it renders the choice between self-employed and incorporated businesses neutral from the taxation perspective. That is, assuming that all profits are distributed, he pays the same amount of tax, whether he conducts his business through a separate legal entity subject to corporation tax, or conducts his business as a self-employed person. In the first case his profit is subject to corporation tax of 33.3, and income tax of 16.7, in total 50 (under the imputation system), or corporation tax of 33.3, and schedular tax of 16.7, again totalling 50. If he does not incorporate his business, but runs it as a self-employed person, he simply pays income tax of 50, which is the same as the total tax burden of 50 under the imputation and schedular system.

Under the exemption system the overall tax burden logically equals the corporate tax rate, as no income tax is levied on the dividend.

2.4. Systems in Member States

For the purposes of this Communication three dividend payment situations are distinguished: domestic, inbound and outbound. Domestic dividends are dividends paid by a company in a Member State to a shareholder in the same Member State. Inbound dividends means dividends paid from another Member State to a shareholder resident in a Member State, outbound means dividends paid from a company in the Member State concerned to an individual shareholder in another Member State.

9 In turn, single schedular rate or half income systems do not fully relieve double taxation of dividend income for lower income taxpayers, whereas the imputation system always achieves that.

Table 1: Domestic dividends: Overview of Member States' and acceding States' dividend taxation systems for individual shareholders receiving domestic dividends

	Classical	**Imputation**	**Schedular**	**Exemption**
Member States	Ireland	Spain, France	Belgium, Denmark, Germany, Luxembourg, Netherlands, Austria, Portugal, Sweden	Greece
Acceding States		Malta	Cyprus, Czech Rep., Hungary, Lithuania, Poland, Slovak Rep., Slovenia	Estonia[10], Latvia

Italy, Finland and the United Kingdom do not appear in the above table, as they apply options or combinations of systems. Italy leaves portfolio investors the choice between the imputation system or a schedular rate of 12.5%. Finland combines the imputation system and the schedular system in such a way that for practical purposes it amounts to an exemption system. The United Kingdom operates an imputation system in combination with a schedular system with two different rates, which for low-income taxpayers amounts to exemption.

Ireland is the only Member State applying a classical system for domestic dividends. It is an interesting case, given its low corporation tax rate of 12.5%. As a result of this low corporate tax rate the economic double taxation resulting from the combined tax pressure of corporate tax and income tax on domestic dividends remains relatively low.

Five Member States apply an imputation system to domestic dividends, including Italy, Finland and the United Kingdom. Ireland, Germany and Portugal had imputation systems too, but abolished them. Greece is the only Member State applying an exemption system.

A majority of eleven Member States apply some form of schedular system to domestic dividends, again including Italy, Finland and the United Kingdom. Malta is the only accession country that applies an imputation system to domestic dividends received by individual shareholders. Two acceding States apply the exemption system, and a majority of seven apply some form of schedular system. It may be worth noting that the US also recently introduced a schedular system[11].

10 The Estonian system is noted as an exemption system, although it has a unique feature: corporation tax is not levied until dividends are paid out. No income tax is levied on domestic dividends. It could also be seen as a system in which profits are exempt in the hands of the company, and in which the tax paid by the company at the same rate as that imposed on personal income is a withholding tax, a pre-payment of the shareholder's tax liability on the dividends.

11 With a rate of 15% (5% for taxpayers in the low income tax bracket), see the Jobs and Growth Tax Relief Reconciliation Act of 2003, of 22 May 2003.

Current developments

Italy has announced that it will abolish its imputation system. Dividends received by individual portfolio shareholders would be subject to a schedular rate of 12,5%[12]. France announced that it would replace its imputation system with a half income system as per 1 January 2005. The tax treatment of inbound dividends by Finland[13] and Austria[14] is the subject of legal proceedings before the ECJ, as a result of requests for preliminary rulings by national courts. Finland is considering abolishing its imputation system[15]. Austria has already adopted legislation in order to bring its law in conformity with EU law[16].

3. LEGAL ANALYSIS

3.1. General

3.1.1. Introduction

According to Article 14 of the EC Treaty "The internal market shall comprise an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaty". Article 56 of the EC Treaty elaborates the free movement of capital.

In the absence of harmonisation direct taxation has remained essentially within the competence of Member States. However, Member States must exercise that competence consistently with Community law[17].

The most relevant case for the taxation of portfolio dividends is *Verkooijen*. The facts in this case were relatively simple: When taxing dividend income, the Netherlands exempted the first 1 000 guilders. However, this exemption only applied to domestic dividends. It did not apply to inbound dividends. The Court ruled that this was not in conformity with the EC Treaty. Various elements of the case are discussed in more detail below.

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12 Legislative Decree of 12 September 2003. The changes should take effect as of 1 January 2004.

13 Case C-319/02, *Manninen*.

14 Case C-315/02, *Lenz*.

15 See the English summary of an extensive report by a working group established by the Finnish Ministry of Finance on http://www.vm.fi/resource/fi/27616.pdf, page 197.

16 Budgetbegleitgesetz 2003.

17 *Verkooijen*, paragraph 32, which refers to Case C-80/94 *Wielockx* [1995] ECR I-2493, paragraph 16, Case C-264/96 *ICI* [1998] ECR I-4695, paragraph 19, Case C-311/97 *Royal Bank of Scotland* [1999] ECR I-2651, paragraph 19.

3.1.2. The free movement of capital

Articles 56 and 58 of the EC Treaty on the free movement of capital are the most relevant ones for issues concerning dividend taxation, as in practice most individual shareholders with foreign shares do not have definite influence over the company's decisions and cannot determine its activities[18].

Pursuant to Article 56 "all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited". Article 56 does not itself contain a definition of the concept of capital movement. Reference should be made in that respect to the nomenclature contained in Annex I to Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the (EEC) Treaty[19]. Although receipt of dividends is not expressly mentioned in that annex as capital movement, it necessarily presupposes participation in new or existing undertakings referred to in Heading I (2) of the nomenclature. The receipt of dividends may also be linked to "Acquisition by residents of foreign securities dealt in on a stock exchange[20]." The ECJ therefore ruled that the receipt by a national of a Member State residing in that Member State of dividends on shares in a company whose seat is in another Member State is covered by Directive 88/361[21]. Consequently, the receipt of dividends is covered by Article 56 of the EC Treaty.

3.1.3. Restrictions and justifications

In order to determine whether a provision of national law is compatible with Article 56 of the EC Treaty it should be established whether it restricts the free movement of capital <u>and</u> if so, whether the restriction can be justified.

Two questions, developed in the ECJ's case law, determine whether there is a restriction on the free movement of capital within the meaning of Article 56 of the Treaty:

- Is the provision liable to dissuade residents of a Member State from investing their capital in companies established in other Member States?[22]
- Is the provision of the Member State liable to constitute an obstacle to companies established in other Member States to raise capital in that Member State?[23]

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18 The ECJ ruled in the case of shareholders with foreign shares giving them definite influence over the company's decisions and the possibility to determine its activities that they were exercising their right of establishment in the sense of Article 43 of the EC Treaty, see Case C-251/98 *Baars* [2000] ECR I-2787, paragraph 22.

19 OJ 1988 L 178/5. The nomenclature is expressly stated not to be an exhaustive list. The substance of Article 67 of the EEC Treaty is now to be found in Article 56 of the EC Treaty

20 Item III.A.2. of Annex I.

21 See *Verkooijen* paragraphs 28 to 30.

22 To that effect 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.

23 *Verkooijen*, paragraph 35.

If either or both the above questions are answered positively, the provision constitutes a restriction on capital movements.

In *Verkooijen* the ECJ ruled that making the grant of a tax advantage relating to taxation of the income of natural persons who are shareholders subject to the condition that the dividends are paid by companies established within national territory constitutes a restriction on capital movements.[24]

3.1.4. Article 58.1. and Article 58.3.

Once a restriction is established, it should be explored whether a justification is applicable.

One of the main exceptions to Article 56 is provided by Article 58.1.(a), which gives Member States the right “to apply the relevant provisions of their tax law which distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested”.

Moreover, on the basis of Article 58.1.(b), Member States may "take all requisite measures to prevent infringements of national law and regulations", in particular those concerned with taxation.

However, the exceptions of Article 58.1. are limited by Article 58.3, which states specifically that the national provisions referred to by Article 58.1. “shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments as defined in Article 56”.

It should be borne in mind that Article 58.1 represents an exception to the fundamental principle of free movement, and must therefore be interpreted restrictively.[25]

The possibility retained for Member States in Article 58 to differentiate between persons in different situations has been upheld in the case law of the ECJ[26]. According to that case law, such provisions may be compatible with Community law in so far as (1) they apply to situations which are not objectively comparable or (2) they are justified by overriding reasons in the general interest. However, these provisions may not in any event be more restrictive than is necessary in order to achieve the aim pursued, that is to say, must be consistent with the principle of proportionality[27].

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24 *Verkooijen*, paragraph 36.

25 Case C-54/99 *Eglise de Scientologie* [2000] ECR I-1335, paragraph 17; Opinion of Advocate General Tizzano in Case C-516/99 *Schmid* [2002] ECR I-4573, paragraph 44.

26 *Verkooijen*, paragraph 43.

27 See, for example, Case C-478/98 *Commission v. Belgium (DEM Eurobonds)* [2000] ECR I-7589, paragraph 41 and Case C-163/94 *Sanz de Lera and others* [1995] ECR I-4821, paragraph 23.

On the basis of *Verkooijen* it can be concluded that the exceptions set out in Article 58.1. are essentially the expression of principles already recognised in the case law[28]. According to the ECJ these exceptions did not justify the restriction on inbound dividends of *Verkooijen*.

3.1.5. *Other justifications*

Member States often invoke justifications based on overriding reasons in the general interest. On only one occasion did the ECJ accept such a justification (the coherence argument, in the Bachmann case, which is discussed further below). All of the following attempted justifications have been rejected by the ECJ.

– the risk of tax avoidance: the ECJ consistently rejects this justification if the legislation at stake does not have the specific purpose of preventing wholly artificial arrangements[29];

– the loss of tax revenue: reduction in tax revenue cannot be regarded as an overriding reason in the public interest which may be relied on to justify a measure which is in principle contrary to a fundamental freedom[30];

– the need for progressivity of the tax system: it is settled case-law that detrimental tax treatment contrary to a fundamental freedom cannot be justified by the existence of other tax advantages, even if those advantages exist[31];

– the existence of lower tax rates in other Member States[32];

– that harmonisation has not been achieved: in the absence of harmonisation at Community level, the Member States must nevertheless comply with Community law[33];

– the effectiveness of fiscal supervision/administrative difficulties[34];

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28 See paragraph 43 of *Verkooijen* .

29 Case C-324/00 *Lankhorst*, not yet published, paragraph 37, *ICI*, paragraph 26, see also Case C-397/98 *Hoechst* [2001] I-1727, paragraph 57.

30 *Lankhorst*, paragraph 36, *Verkooijen* paragraph 59, *ICI* paragraph 28.

31 Paragraph 97 of Case C-385/00 *De Groot*, not yet published, where the ECJ refers to: with respect to the freedom of establishment, Case 270/83 *Commission* v *France* [1986] ECR 273, paragraph 21, Case C-107/94 *Asscher* [1996] ECR I-3089, paragraph 53, and *Saint-Gobain*, paragraph 54; with respect to the freedom to provide services, Case C-294/97 *Eurowings Luftverkehr* [1999] ECR I-7447, paragraph 44; and, with respect to the free movement of capital, Case C-35/98 *Verkooijen* [2000] ECR I-4071, paragraph 61.

32 Paragraph 44 of Case C-294/97 *Eurowings* [1999] ECR I-7449, also Case C-270/83 *Commission/France* [1986] p. 273, paragraph 21 and Case C-107/94 *Asscher* [1996] I-3089, paragraph 53,

33 Paragraph 34 of Case C-18/95 *Terhoeve*, [1999] I-345, on social security legislation, where the ECJ refers to Case C-120/95 *Decker* v *Caisse de Maladie des Employés Privés* [1998] ECR I-1831, paragraphs 22 and 23, and Case C-158/96 *Kohll* v *Union des Caisses de Maladie* [1998] ECR I-1931, paragraphs 18 and 19).,

34 See, for instance, Case C-80/94 *Wielockx* [1995] ECR I-2493 and Case C-250/95 *Futura* [1997] ECR I-2471.

– the absence of reciprocal treatment under a double tax treaty: Treaty rights are unconditional and cannot be made subject to the contents of a tax treaty[35];

– aims of a purely economic nature, such as the intention to promote the economy of the country by encouraging investment by individuals in companies with their seat in that country[36];

– other advantages are enjoyed by the person suffering from the restriction[37].

3.2. Inbound dividends

This Chapter 3.2. examines various situations concerning inbound dividends. Each time the conclusion is the same: Under the EC Treaty Member States cannot effectively tax inbound dividends higher than domestic dividends.

3.2.1. Inbound dividends: Exemption

Member States which exempt (part of the) domestic dividends should extend this exemption to inbound dividends. This conclusion follows immediately from *Verkooijen.*[38]

3.2.2. Inbound dividends: Classical versus imputation system

Under imputation system credits are usually only given for domestic dividends. The effect of not granting an imputation credit to inbound dividends is that the taxpayer pays more income tax on inbound dividends than on domestic dividends. The example below illustrates the higher taxation, assuming a corporate tax rate of 30% in both countries, a marginal income tax rate of 50%, a full credit for the 30% corporation tax in the domestic situation, and no withholding taxes.

Example 2: The effect of not granting a credit on inbound dividends

	Domestic dividend	**Inbound dividend**
Profit	100	100
Corporation tax 30%	30	30
Dividend	70	70
Grossed-up dividend	100	
Income tax 50%	50	35
Full credit	30	
Remaining income tax	20	
Net dividend	50	35

35 Paragraph 26 of Case C-270/83 *Avoir Fiscal* [1986], p. 173.

36 *Verkooijen*, paragraph 48, where the ECJ refers to Case C-120/95 *Decker* v *Caisse de Maladie des Employés Privés* [1998] ECR I-1831, paragraph 39, and Case C-158/96 *Kohll* v *Union des Caisses de Maladie* [1998] ECR I-1931, paragraph 41.

37 Case C-270/83 *Commission v. France* [1986] ECR I-273, Case C-107/94 *Asscher* [1996] ECR I-3089, 3113, Case C-307/97 *Saint Gobain* [1999] ECR I-6163, 6181, Case C-294/97 *Eurowings* [1999] ECR I-7449, 7463.

38 France exempts the first € 2.440 of dividends received by married couples, but inbound dividends are excluded from the exemption. The Commission therefore opened an infringement procedure against France on this issue, see IP/03/990 of 10.7.2003.

The effect is clear: Of an original company profit of 100 just 35 remains in the hands of the shareholder if the dividend came from a foreign company, whereas 50 remains of a profit originating in the same country. So if for inbound dividends the imputation country applies the classical system, the result is full economic double taxation. The legal question can now be reformulated: Is it compatible with Article 56 of the EC Treaty for a Member State to apply the classical system to inbound dividends, if it applies an imputation system to domestic dividends? Or, in other words, if a Member State takes unilateral measures to avoid double taxation on domestic dividends should it also apply them in international situations?

Effectively subjecting inbound dividends to higher taxation than domestic dividends dissuades national residents from investing in the shares of companies established in other Member States. It is therefore a restriction on capital movements contrary to Article 56 EC.

Moreover, the ECJ will also examine whether a measure has a restrictive effect on companies established in other Member States[39]. In this case it constitutes an obstacle to the raising of capital in the Member State concerned since dividends paid by such companies to national residents receive less favourable tax treatment than dividends distributed by a company established in the Member State. As a result their shares are less attractive to investors residing in that Member State than shares in companies in another Member State.

An imputation system which is not extended to inbound dividends is therefore a restriction of the free movement of capital.

3.2.2.1. Overriding reason in the general interest

The restriction being established, it is necessary to examine whether the restriction may be objectively justified by any overriding reason in the general interest[40].

Coherence

As regards the need to preserve the coherence of the tax system, the ECJ pointed out in *Verkooijen*[41] that in *Bachmann*[42] a direct link existed, in the case of one and the same taxpayer, between the grant of a tax advantage and the offsetting of that advantage by a fiscal levy, both of which related to the same tax.

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39 *Verkooijen*, paragraph 35.

40 Ibidem, paragraph 46.

41 Ibidem, paragraph 28.

42 Case C-204/90 *Bachmann*, [1992] ECR I-249.

In *Verkooijen* all Member States which submitted observations maintained that restricting the exemption to domestic dividends was justified by the need to preserve the coherence of the Netherlands tax system. In their view, the exemption should be reserved to shareholders who receive domestic dividends because only Dutch companies pay Dutch corporation tax. One Member State argued that if the Netherlands were to grant the exemption to inbound dividends such dividends might entirely escape taxation in the Netherlands. Another Member State argued that exemption of inbound dividends would enable the shareholders to enjoy tax relief in both states.

A Member State applying an imputation system without granting a credit for inbound dividends may equally call on fiscal coherence. It might argue that Article 58 was intended specifically to cover the case of such an imputation system. It might claim that unlike the situation in *Verkooijen*, there is a direct link in such a system between the taxation of the company's profits and the tax credit granted to the shareholder, ensuring the coherent tax treatment of the company's profit both in its hands and in those of the shareholder. It might claim that there are not two separate taxes, but an integrated system in which the same income is dealt with in the taxation of two persons.

However, the ECJ ruled in *Verkooijen*[43] and *Baars*[44] that the coherence argument was not applicable, as no direct link existed between the taxation of the shareholders and the corporate tax levied on corporations, which meant two separate taxes from different taxpayers. The ECJ confirmed this jurisprudence in *Bosal*[45].

In conclusion, the coherence argument cannot be successfully invoked to defend the refusal of an imputation tax credit for inbound dividends, as in this specific situation it also concerns corporation tax levied on a company and income tax charged on an individual shareholder, hence two separate taxes levied on different taxpayers, without a direct link.

3.2.2.2. The proportionality principle

Assuming that notwithstanding the above analysis a justification were to be found to defend the refusal of credits to inbound dividends, it should still be examined whether such a refusal was "of such a nature as to ensure achievement of the aim in question and not go beyond what was necessary for that purpose"[46].

In essence, an imputation system is nothing more than a calculation method to calculate the income tax rate applicable to a dividend. The aim of imputation systems is to eliminate the double taxation resulting from the classical system. As has been demonstrated above, schedular systems achieve the same aim, at least for the high income taxpayer, without the restriction, i.e. the refusal of credits to inbound dividends. It is therefore disproportionate to maintain an imputation system for domestic dividends and a classical system for inbound dividends.

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43 As in Paragraph 58 of *Verkooijen*.
44 Paragraph 40.
45 Case C-168/01 *Bosal*, not yet published, paragraph 29.
46 Case C-436/00 *X, Y against Riksskatteverket*, not yet published, paragraph 49.

3.2.3. *Inbound dividends: Classical versus schedular*

There may be Member States which apply a schedular system to domestic dividends whilst applying the classical system to inbound dividends.

As example 3 shows, this leads to much higher taxation of the inbound dividend.

Example 3: The effect of not applying the schedular system to inbound dividends

	Domestic dividend	**Inbound dividend**
Profit	100	100
Corporation tax 30%	30	30
Dividend	70	70
Schedular tax 25%	17,5	
Income tax 50%		35
Net dividend	52,5	35

This is a clear restriction of the free movement of capital in the sense of Article 56 of the EC Treaty.

There seems to be no justification for such a restriction. Many Member States operating a schedular system apply it to both domestic and inbound dividends. Nothing would prevent the other States with a schedular system doing the same, apart from budgetary reasons and possibly the wish to stimulate investors to invest domestically. Neither justification is acceptable under the EC Treaty.

3.2.4. *Inbound dividends: Credit for foreign withholding tax*

There may also be a problem with juridical double taxation arising from credits for foreign withholding taxes. Inbound dividends are subject to higher taxation than domestic dividends if the country, applying a schedular or a classical system, does not give a credit for foreign withholding tax but applies the deduction[47] method.

Example 4: Higher taxation of inbound dividends

Schedular system, withholding tax rate 15%, schedular rate 25%

	Domestic dividend	**Inbound dividend**
Dividend	100	100
Foreign withholding tax 15%		15
Dividend after foreign withholding tax		85
Schedular tax 25%	25	21,25
Net dividend	75	63,75

47 Under the deduction method the foreign tax is deducted from the gross dividend. The result is the base for the calculation of the domestic tax on the dividend.

Classical system, withholding tax rate 15%, marginal income tax rate 50%

	Domestic dividend	**Inbound dividend**
Dividend	100	100
Foreign withholding tax 15%		15
Dividend after foreign withholding tax		85
Income tax 50%	50	42,50
Net dividend	50	42,50

It is clear that the higher tax burden on inbound dividends constitutes a restriction in the sense of Article 56 of the EC Treaty on individual taxpayers to invest in foreign shares.

Such a Member State may argue that it has a non-discriminatory system, which subjects both domestic and inbound dividends to the same tax treatment, and that the restriction is the result of the foreign withholding tax.

However, this argument cannot be accepted if the Member State's relevant tax treaty gives the other State the right to levy a withholding tax (generally of 15%), and if Article 23 states that the Member State shall give a credit for this withholding tax.

In such circumstances the restriction of the free movement of capital would be caused by the Member State itself, and not by the source State, as the OECD Model and the applicable tax treaties require that the residence State must provide the relief.

3.3. Outbound dividends

Chapter 3.3. examines various situations concerning outbound dividends. As with inbound dividends, the conclusion is similar: Under the EC Treaty Member States cannot effectively tax outbound dividends higher than domestic dividends.

3.3.1. Outbound dividends: limit on taxation

Article 56 prohibits a Member State from granting more favourable treatment to investments by domestic shareholders than to investments by foreign shareholders. Higher taxation of outbound dividends than of domestic dividends therefore constitutes a restriction on the free movement of capital. So, for example, a Member State cannot levy tax a withholding tax on outbound dividends and exempt domestic dividends, as it would tax outbound dividends higher than domestic dividends.

It should be noted that a simple comparison of the withholding tax rate on domestic dividends with the withholding tax rate on outbound dividends is not sufficient. The basis of comparison should be for the domestic dividends the combined effect of any domestic withholding tax rate plus the domestic income taxation and for the outbound dividend the withholding tax rate on the outbound dividend.

3.3.2. *Outbound dividends: Right of assessment*

If a Member State has a schedular system and offers residents the right to opt for assessment of the dividend income under the normal income tax rules, it should extend that right to non-residents who are in a situation comparable to residents, on the basis of the *Schumacker* case. According to *Schumacker*[48] a non-resident individual portfolio investor would be in a situation comparable to a resident investor when he earns his income entirely or almost exclusively from dividends originating in a Member State and does not receive in his Member State of residence sufficient income to be subject there to taxation there in a manner enabling his personal and family circumstances to be taken into account (by his Member State of residence).

4. ECONOMIC EFFECTS

The outcome of the legal analysis above is clear: if Member States integrate corporate taxation with income taxation by using the imputation system or a schedular system, the EC Treaty obliges them to extend this integration to inbound dividends.

The theoretical economic impact of integration depends mainly on its possible effects on tax neutrality. As the Ruding report noted: "The absence of tax neutrality with respect to the location of investment within the Community constitutes a potential impediment to the realisation of the full benefits from the completion of a single internal market. By according preferential treatment to domestic dividends, or by discriminating against investments in some Member States, non-neutral tax rules can distort the allocation of capital within the Community. Resources are misallocated in so far as capital inputs are directed from their most productive uses – that is, those with the highest rates of return before taxes – to locations where such inputs are less productive, but yield greater after-tax returns as a consequence of their relatively favourable tax treatment. The resulting economic inefficiency manifests itself in reduced capital productivity, which impairs the Community's international competitiveness, and lower levels of total output and living standards in the Community as a whole"[49]. In addition, not extending integration to inbound dividends would also have distorting effects on cross-border mergers and reorganisation decisions, as before and after these business operations, dividends arise in different countries and the dividends would receive a different fiscal treatment. It follows that any improvement of the situation would lead to a better functioning Internal Market.

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48 Case C-279/93 *Schumacker* [1995] I-225, paragraph 47.

49 Ruding Report, page 34.

Tax neutrality is usually discussed in relation to Capital Import Neutrality (CIN) and Capital Export Neutrality (CEN). CIN requires that the marginal effective tax rate on investors in any given State be the same, regardless of the investors' State of residence. Under CEN "the tax system provides no incentive for resident investors in a given country to invest at home rather than abroad, or vice versa, because resident investors pay the same total domestic-cum-foreign tax on their worldwide income regardless of the domestic/foreign composition of that income"[50]. CIN and CEN are often discussed in the context of companies directly investing in other companies. In that context CIN is achieved via the exemption method, and CEN via the credit method. It should be noted that the focus of this Communication is different, as it deals with dividends received by individual shareholders who are portfolio investors. However, the CIN and CEN concepts could also be transposed to their situation.

CEN applied to individual shareholders would mean that their domestic and foreign investments would suffer the same effective tax pressure (that is the combined effect of all taxes involved, corporation tax, withholding tax and income tax). CIN plays in practice no role for individual shareholders. No Member State or acceding State exempts inbound dividends paid to individual shareholders from income taxation. In combination with the fact that most Member States tax dividends received by individual shareholders differently, unless this taxation is harmonised, CIN can not be achieved and CEN is the dominant principle.

It should be noted that given the absence of full scale corporate tax harmonisation (which is not advocated by the Commission) complete CEN is in practice extremely difficult if not impossible to achieve, both for schedular and imputation systems. In order to achieve 100% neutrality, schedular systems should have different schedular rates depending on the Member State from which the dividend was paid. The rate should even take into account the underlying corporation tax paid by all lower tier subsidiaries. In the same way, the calculation of the underlying tax component of the imputation credit relief would be a particularly complicated matter. For direct investment by companies some Member States do calculate the underlying tax, taking into account the tax paid by lower-tier subsidiaries. However, for individual portfolio investors this seems unfeasible, as they do not have any control over the companies they invest in. They are therefore not likely to be able to obtain the necessary information.

In practice, therefore, a pragmatic solution is for schedular systems to apply the same rate to domestic dividends as to inbound dividends. Similarly under imputation systems, one could simply apply the same imputation credit to inbound dividends as to domestic dividends, if it is preferred to avoid having to calculate the underlying corporation tax abroad. As demonstrated in Chapter 3, the effects of schedular and imputation systems are equivalent in this respect.

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50 Paragraph 3.7 of "Double Taxation Relief For Companies: A Discussion Paper", by Mike Waters of the UK Inland Revenue, 10 March 1999, to be found on http://www.inlandrevenue.gov.uk/consult/dtrc.pdf

It follows that because the foreign corporation tax may be higher or lower than the domestic corporation tax, the effective tax rate on inbound dividends under schedular and imputation systems may differ from the national marginal income tax rate. Full CEN is therefore not achieved. However, this respects the internationally agreed principle that business profits should be taxed in the country where they arise, as well as the principle that in the present state of Community law, Member States are free to set their corporation tax rates and bases. In other words, in this context the reduction of cross-border neutrality is a price to be paid for Member States' sovereignty to set their own corporate taxes.

5. CONCLUSION

Member States operate different systems for the taxation of dividend payments in the hands of individuals. For domestic dividends most Member States prevent or reduce the economic double taxation resulting from the levying of corporation tax and income tax from the same income by applying either an imputation system or a schedular system.

Where, in applying their systems, Member States differentiate between the tax treatment of domestic and inbound or outbound dividends this can be a restriction on cross-border investments and it can result in fragmented capital markets in the EU.

In its developing case law the ECJ has considered this issue on the basis of the provisions on the free movement of capital. It has, in the main case considered in this Communication, given a clear ruling on the incompatibility of a measure which provided for a different tax treatment of domestic and inbound dividends.

The Commission believes that analysis of this case law leads to fundamental conclusions about the design of dividend taxation systems: Member States cannot levy higher taxes on inbound dividends than on domestic dividends. Likewise, they cannot levy higher taxes on outbound dividends than on domestic dividends.

Member States may in the original design of their dividend taxation systems have focused on their domestic effects, which may have resulted in unlawful restrictions on inbound and outbound dividends. It follows that Member States should re-examine their systems in the light of the current Treaty provisions.

As outlined in this Communication, it is possible to provide for methods of relief that are compatible with the Treaty, while maintaining possibilities to tax in a relatively straightforward manner. A number of Member States have already introduced such methods; others are in the process of doing so. These changes should help to optimise the allocation of capital in the Internal Market, even though full neutrality remains out of reach, in the absence of tax harmonisation.

In deciding on what to do, Member States should adopt a co-ordinated approach to ensure a rapid removal of the tax obstacles that exist, thereby creating a more stable and investment-friendly environment and removing the uncertainty created by potential legal conflict and litigation.

The Commission wishes to promote this co-ordination in the interests of both individual investors and business and overall in the interest of ensuring the maximum efficiency of the Internal Market with its consequent positive effects on the competitiveness of the Union in the global marketplace.

The Commission therefore calls on the Member States to work together with it to deal quickly and effectively with the issues examined in this Communication. If solutions cannot be found despite the clear logic of such an approach, the Commission, in line with its responsibility as guardian of the Treaty, will take the necessary steps to ensure effective compliance with the Treaty, including bringing the matter before the ECJ on the basis of Article 226 of the EC Treaty.

The Commission invites the Council, the European Parliament and the European Economic and Social Committee to give their opinion on this Communication.
