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The Court of Justice in its November 19, 2009, judgment in Commission of the European Communities v. Italian Republic (C-540/07) finally settled the dispute over withholding taxes on outbound dividends. However, the judgment raises difficult questions concerning the application of the European Economic Area Agreement.

The ECJ held that Italy’s discriminatory tax treatment of outbound dividends violated EU law and the EEA Agreement but that the treatment was justified in the case of the EEA. (For the ECJ decision, see Doc 2009-25447 or 2009 WTD 222-14.)

Facts

According to the Italian rules under review, dividends distributed to resident companies are almost tax free (only 5 percent of the dividend is taxable). However, dividends distributed to nonresident companies are taxable. Even if portions of that tax can sometimes be repaid on application, the ECJ stated in its decision that it is “undisputed that the Italian legislation subjects dividends distributed to companies established in other Member States to a higher rate of taxation than that imposed on dividends distributed to resident companies.”

The EC Treaty

Countering the European Commission’s claim that the rules conflicted with article 56 EC on the free movement of capital, Italy first argued that dividends distributed to nonresident companies are not treated unfavorably because the Italian withholding tax would be credited in the residence state for the receiving company under the tax treaties. In earlier cases, Amurta (C-379/05) in particular, the ECJ had held that it is possible for a credit under tax treaties to have this effect. However, this would require that the withholding tax is completely credited; the difference in treatment between resident and nonresident companies “does not totally disappear unless the tax withheld at source under national legislation can be set off against the tax due in the other Member State in the full amount of the difference in treatment arising under the national legislation,” the Court said. Because of the so-called ordinary credit restriction in the tax treaties, under which the credit amount is restricted to the tax calculated in the residence state of the shareholder, a complete credit is dependent on the rules in that state, requiring that the dividends are taxed in that state and at a sufficient tax rate to produce a tax amount large enough to completely cover the withholding tax. Echoing the reasoning of the Court in Amurta, in which the Court stated that the residence state of the distributing company could not rely on domestic credit rules in the residence state of the receiving company, the Court held that a possible full credit of the withholding tax “is not guarantied by Italian legislation”; it “depends not on the Italian Republic but on the tax rules laid down by the other Member State,” and Italy could not rely on that.

Second, Italy argued that account must be taken of the Italian system as a whole, the object of which was to ensure that dividends distributed to individuals as the final beneficiaries were taxed; thus, the taxation of resident individuals and nonresident taxpayers were in reality equivalent. The Court dismissed this argument by stating that the position of an individual taxed under the national tax regime and companies subject to withholding tax in Italy were not comparable. For the same reasons, the Court dismissed Italy’s claim that the rules could be justified with reference to the cohesion of the tax system and the maintenance of a balanced distribution of the power to tax. On the contrary, the Court found nonresident shareholders taxed on dividends from Italian companies to be in a comparable position to companies resident in Italy and receiving dividends from Italian companies. The Court therefore also dismissed Italy’s claim that the rules could be justified with reference to resident and nonresident shareholder companies not being in comparable situations.
Ultimately, Italy claimed that the rules were justified because they were necessary to fight tax evasion. The reasoning seems to have been that resident individual shareholders could otherwise benefit from hiding behind a nonresident company and thus evade the Italian dividend tax. This argument was dismissed for two reasons. First, a justification based on risk for tax evasion is permissible only ‘‘if it concerns purely artificial contrivances, the aim of which is to circumvent law, so that any general presumption of evasion is excluded.’’ The rules under consideration in the present case were of such a general nature and therefore could not be justified by reference to the fight against tax evasion. Second, the Court referred to the exchange of information directive (77/799/EEC) as an appropriate means for the Italian tax authorities to provide information as to the ownership of the nonresident shareholder companies.

The EEA Agreement

While this judgment is in harmony with earlier interpretations of the capital freedom rule and withholding taxes, the case raises new and difficult concerns regarding the EEA Agreement.2

The Court began with some general comments on the interpretation of the EEA Agreement, which should by now be uncontroversial: Considering that ‘‘one of the main objectives of the EEA Agreement is to realise as completely as possible the free movement of goods, persons, services and capital throughout the whole of the European Economic Area (EEA),’’ so that the internal market realised in the territory of the Community is extended to the EFTA States’’ it is for the ‘‘Court in that context to ensure that the rules of the EEA Agreement which are identical in substance with those of the Treaty are interpreted in a uniform manner within the Member States.’’

With this in mind, it is unsurprising that the Court rather succinctly found that the free capital movement rule of the EEA Agreement (article 40 EEA) should be interpreted to mean that there was a restriction in this case.3

However, the Court found that ‘‘that restriction is justified by the overriding reason in the public interest regarding the fight against tax evasion.’’ Citing Skatteverket v. A (C-101/05), the Court said the exchange of information directive does not apply in an EEA context and that the tax treaties do not contain provisions laying down an obligation to supply information.’’ Lastly, the Court found that the rules were ‘‘appropriate to ensure the realisation of the objective in question without going beyond what is necessary in order to attain it.’’

This reasoning is surprising even if it is by now commonly accepted that the fact the mutual assistance directive does not apply in an EEA context is relevant for possible justifications based on supposed tax avoidance or evasion. First, the tax treaties with both Norway and Iceland do in fact contain exchange of information clauses.4 Admittedly, they are based on the 1963 version of the OECD model convention but should nevertheless provide sufficient bases to obtain

1See para. 64 in Advocate General Juliane Kokott’s July 16, 2009, opinion in the case, Doc 2009-17711, 2009 WTD 149-2. Admittedly, it is not entirely clear whether this refers to the risk that the dividends are later distributed to individuals resident in Italy without being declared by them (which would amount to tax evasion, not only tax avoidance or circumvention of tax law), or only to the fact that the distribution of profits to a nonresident company owned by resident Italian individuals would not — without the disputed Italian rule — trigger any dividend tax in Italy. The French version of the judgment uses the expression ‘‘fraud fiscal,’’ which indicates that the first-mentioned view is the correct one.

2Indeed, according to information given in the AG’s opinion, the case started as an EEA Agreement case, initiated by a complaint from a Norwegian company that was a shareholder of an Italian company. The commission later extended the case to also cover distributions to companies resident in an EU state.

3In the EEA context, the case also concerned the freedom of establishment rule (article 31 EEA) because the parent-subsidiary directive (90/435/EEC) does not apply under the EEA Agreement. The Court, again unsurprisingly, decided the case in exactly the same way under this rule as under the freedom of capital rule.

4Treaties with Iceland and Norway; Italy has no tax treaty with Liechtenstein.

5Article 27 of the tax treaty between Italy and Norway from 1985 reads:

Article 27 Exchange of Information

1. The competent authorities of the Contracting States shall exchange such information as is necessary for the carrying out of this Convention or of the domestic laws of the Contracting States concerning taxes covered by this Convention insofar as the taxation thereunder is not contrary to this Convention as well as to prevent fiscal evasion. The exchange of information is not restricted by Article 1. Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes which are the subject of the Convention. Such persons or authorities shall use the information only for such purposes. These persons or authorities may disclose the information in public court proceedings or in judicial decisions.

2. In no case shall the provisions of paragraph 1 be construed so as to impose on a Contracting State the obligation:

a) to carry out administrative measures at variance with the laws or the administrative practice of that or of the other Contracting State;
the necessary information. Further, and more importantly, Italy is a party to the OECD-Council of Europe Convention on Mutual Administrative Assistance in Tax Matters of 1988, and this convention certainly provides ample possibilities for Italian tax authorities to get the necessary information. The Court wrote that Italy “has maintained, without being contradicted” that no exchange of information rules apply in relation to Iceland and Norway. For unknown reasons, the commission must have chosen not to cite the exchange of information clauses in the tax treaties and the fact that Italy had joined the OECD-Council of Europe convention. The commission could not have been ignorant of the importance of this information because the advocate general in her opinion explicitly invited the commission to provide it. 7

As explained above, when discussing the tax evasion justification under the EC Treaty, the ECJ based its decision on two independent legal considerations: First, it found that the rule in question was too general to apply under the “purely artificial arrangements” requirement for rules whose purpose is to combat tax evasion. Second, the Court found that Italy could avail itself of the mutual assistance directive to get the necessary information, implying that the rule in question was disproportional. When discussing the EEA Agreement, the Court found that the latter of these considerations was not applicable in the EEA context. However, the Court did not address the first of the considerations. One would think that the requirement that rules to combat tax avoidance/evasion should target purely artificial arrangements and not have the character of being “a general presumption of tax avoidance or evasion” applied in an EEA Agreement context just as much as in an EC Treaty context. Any other view is difficult to harmonize with the Court’s introductory remarks, referred to above, on the necessity of interpreting the EEA Agreement and the EC Treaty in a uniform manner. The AG’s opinion is not helpful on this point, as her opinion is framed in the same manner as the judgment of the Court.

New and Unanswered Questions

As previously stated, the judgment raises new questions in an EEA Agreement context. One question is: What applies in the relationship between Italy and Norway (and Iceland) on this issue for the time being? For instance, can a Norwegian company receiving dividends from an Italian company claim that the result of the judgment does not apply because the Court was not sufficiently informed as to the extent of information exchange instruments, and thus successfully argue that the restriction cannot be justified after all?

A second question is whether the Court’s lack of discussion, in the EEA Agreement context, of whether rules to combat tax evasion must be targeted and not have the character of general presumptions should be understood to mean that this requirement does not apply in an EEA context. Such an interpretation would have potentially far-reaching consequences in that it would create an opening for the application of all sorts of domestic antiavoidance rules. This could amount to drawing the decision too far; such far-reaching consequences should require much more explicit support than what is found in this decision.

Lastly, one can wonder whether the decision may have domestic law consequences in Norway. In Fokus Bank (E-1/04) the European Free Trade Association Court found, in an advisory opinion, that the Norwegian withholding tax on dividends conflicted with the EEA Agreement because nonresident shareholders were taxed less favorably than resident shareholders (who were entitled to a tax credit). Following that decision, several taxpayers have claimed compensation for damages from the Norwegian state based on the argument that the EEA Agreement was not correctly implemented in Norway. These cases are finding their way through the court system in Norway. One can question whether the state, based on the Commission v. Italy judgment, can claim that the rules were after all not contrary to the EEA Agreement in cases where the shareholder was a resident of a state with which Norway did not have sufficient exchange of information agreements (which, at that time, also included the U.K.).

b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;

1c) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process or information, the disclosure of which would be contrary to public policy (ordre public).

The Iceland-Italy tax treaty of 2002, article 27, is substantially similar. However, this treaty only came into force on October 14, 2008. For reasons explained below, this fact should not influence the result.

6Admittedly, Italy was not a party to that convention when the case was initiated; the convention came into force for Italy on May 1, 2006. However, the commission’s reasoned opinion was dated July 4, 2006, and the time limit for Italy to comment on that opinion was two months later. According to a well-established interpretation of article 226, para. 2 EC, the object of an infringement case is the rules in force at that point of time.

The OECD-European Council Convention came into force for Norway on April 1, 1995, and for Iceland on November 1, 1996. Liechtenstein is not a party to this convention.

7AG opinion para. 80.

8It is worth noting that — contrary to the exchange of information argument — this argument was applicable to Liechtenstein as well. Thus, striking down the Italian rules based on this argument would mean that withholding taxes could not be levied on dividends distributed to corporate shareholders resident in Liechtenstein (in addition to Iceland and Norway).
Such an argument should not succeed, however. The reason the existence, or nonexistence, of an exchange of information treaty became so important in *Commission v. Italy* was Italy’s argument that the purpose of the withholding tax was to combat tax evasion. However, that was (and is) not the purpose of the Norwegian withholding tax on dividends.

In *Fokus Bank*, the EFTA Court found that the main purpose of the withholding tax was to protect the national tax base.9 Though the court did not rule out possible other purposes as well, countering tax avoidance and evasion was not mentioned. The argument of protecting the tax base could not succeed even if there were widespread information exchange. Therefore, a possible lack of exchange of information treaty provisions should have no impact on whether the Norwegian withholding tax violated the EEA Agreement. Also, it is the EFTA Court that interprets the EEA Agreement regarding whether Norwegian tax law violates that agreement, and that court made its decision on that issue in the *Fokus Bank* case in 2004, albeit in an advisory opinion.

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9 See case E-1/04 *Fokus Bank*, para. 33.

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