COLLEGE PENSION PLAN: GERMANY'S TAXATION OF NON-RESIDENT PENSION FUNDS CHALLENGED

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In *College Pension Plan of British Columbia v Finanzamt München Abteilung III ("College Pension Plan")*,[2] the Court determined that German withholding taxes on dividends paid to non-resident pension funds were incompatible with the free movement of capital.

Background

College Pension Plan of British Columbia ("CPP") constituted a trust under Canadian law and under German law was treated like a pension fund. In the years 2007-2010, pensions funds like CPP were governed by the Law on the supervision of insurance bodies (Versicherungsaufsichtsgesetz) in Germany. Under the Law on corporation tax (Körperschaftsteuergesetz), CPP was subject to a limited tax obligation in Germany on its German dividend income. This was collected by way of a withholding tax of 25% on gross dividends. 2/5ths of the withholding tax was reimbursed to non-resident funds retrospectively, leaving an effective tax burden of 15%. This amounted to a definitive tax on the dividend income for non-resident funds.

Non-resident funds were not allowed to set the withholding tax against corporate income taxes due and were denied a deduction for professional expenditure from their taxable income.

From 2007-2010, CPP held shares in a number of German corporations as portfolio investments. None of the shareholdings exceeded 1% of the capital of those companies.

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2 *College Pension Plan of British Columbia v Finanzamt München Abteilung III ("College Pension Plan"),* C-641/17, ECLI:EU:C:2019:960.

CPP argued that its tax treatment was less favourable than that imposed on German resident funds. It submitted that German resident funds could receive dividends free of tax because they were able to offset the 15% withholding tax paid on dividends against any corporation tax payable in the tax assessment procedure. This advantage was denied to non-resident funds.

CPP also contended, in relation to resident pension funds, that allocations to provisions for the payment of future pensions were considered to constitute professional expenses, which reduced the corporation tax under the tax assessment procedure. This advantage was not made available to non-resident funds.

Since the German Finance Court in Munich (Finanzgericht München) was unsure as to the application of EU law in CPP's situation, it referred the matter to the CJEU for a preliminary ruling.

Question 1: Was there a Restriction on Article 63 TFEU

The Court highlighted, in paragraph 48, that –

> "the measures prohibited by Article 63(1) TFEU, as restrictions on the movement of capital, include those that are such as to discourage non-residents from making investments in a Member State or to discourage that Member State's residents from doing so in other States".

The Court applied its equal treatment principle, in paragraph 49, pointing out that –

> "the less favourable treatment by a Member State of dividends paid to non-resident pension funds, compared to the treatment of dividends paid to resident pension funds, is liable to deter companies established in a Member State other than that Member State from pursuing investments in that same Member State and, consequently, amounts to a restriction of the free movement of capital, prohibited, in principle, under Article 63 TFEU".

The Court noted that applying a heavier tax burden to non-resident funds was less favourable treatment. In paragraph 51, the Court stressed that under the German legislation at issue –

> "pension funds are subject, in relation to the dividends distributed to them, to two different sets of tax rules, the application of which depends on whether they are resident in the territory of the Member State of the company distributing the dividends".

The Court concluded that dividends paid to non-resident funds are subject to less favourable tax treatment than that applied to dividends paid to resident funds since the former were subject to a 15% withholding tax which was definitive and the latter were exempt from tax, in whole or in part. Therefore, the German legislation at issue constituted a restriction on Article 63 TFEU that required justification.

Justification

The Court noted that Article 63 TFEU could be restricted by Article 65(1)(a) TFEU, subject to the conditions laid down in Article 65(3) TFEU. The Court explained, in paragraph 63, that –

> "the derogation in Article 65(1)(a) TFEU is itself limited by Article 65(3) TFEU, which provides that the national provisions referred to in paragraph 1 of that article 'shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments as defined in Article 63 [TFEU]' …"

Consequently, the Court pointed out that a distinction had to be made between the differences in treatment authorised by Article 65(1)(a) TFEU and the discrimination prohibited by Article 65(3) TFEU. The Court indicated that in such circumstances, in order to comply with the free movement of capital, any difference in treatment must concern situations that are not objectively comparable or must be justified by an overriding reason in the general interest.

Comparability

The Court stressed, in paragraphs 65 and 66, that –

> "the comparability of a cross-border situation with an internal one must be examined having regard to the aim pursued by the national provisions at issue as well as their purpose and content …
>
> as soon as a Member State, either unilaterally or by way of a convention, imposes a charge to tax on the income not only of resident taxpayers but also of non-resident taxpayers from dividends which they receive from a resident company, the situation of those non-resident taxpayers becomes comparable to that of resident taxpayers …"

The Court rejected the argument that the different treatment at issue arose from the application of different taxation arrangements by Germany to residents and non-residents. In coming to this conclusion, the Court distinguished its earlier *Truck Center* judgment[3] that was relied upon by the German government. The Court explained that the German rules treated dividends paid to resident pension funds as

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3 See *Belgian State - SPF Finances v Truck Center SA ("Truck Center"),* C-282/07, ECLI:EU:C:2008:762. For a detailed analysis by this author, see Tom O'Shea, "*Truck Center*: A Lesson in Source Vs. Residence Obligations in the EU", Tax Notes International, Feb. 16, 2009, 593-601.

ultimately being exempt from tax, in whole or in part, whereas dividends paid to non-resident funds were taxed at the rate of 15% which was definitive in nature. This conferred an advantage on pension funds that were resident in Germany.

The Court also highlighted, in paragraph 81, that –

> "A non-resident pension fund, which allocates the dividends received to provisions for pensions that it will have to pay in the future, intentionally or pursuant to the law in force in its State of residence, is in that regard in a situation comparable to that of a resident pension fund".

The Court stated that this matter had to be verified by the national court. The Court explained that if the national court finds that resident and non-resident funds are in a comparable situation in relation to the national rules, it was still necessary to ascertain whether a general interest justification was applicable in this case.

General Interest Justifications

Germany put forward three possible justifications – the need to ensure a balanced allocation of taxing rights between the Member States, the need to safeguard the coherence of the German tax system and the need to ensure the effectiveness of fiscal supervision.

Balanced Allocation of Taxing Rights

While the Court accepted that the need to preserve a balanced allocation of taxing rights between the Member States was a general interest justification acceptable to the Court, in this instance that justification did not apply since Germany exempted completely or almost completely dividends paid to resident funds.

Coherence of the Tax System

In relation to the coherence of the tax system submission, the Court rejected it as a justification in this case, pointing out that for such a justification to work there had to be a direct link between the tax advantage in question and the charging of a particular tax levy. The Court noted that the German Government did not rely on the existence of such a direct link in this instance.

Effectiveness of Fiscal Supervision

Lastly, the Court dismissed the need to ensure the effectiveness of fiscal supervision as a justification in this case, pointing out that the German Government had not shown how its national rules were suitable for attaining that objective.

The Court's Conclusion on Question 1

The Court concluded that the German rules at issue were incompatible with the free movement of capital contained in Article 63 TFEU, subject to the verification by the national court mentioned above.

Question 2: Is Article 64(1) TFEU Applicable?

The next issue that the Court had to determine was whether the German rules at issue fell within the derogation contained in Article 64(1) TFEU, in essence, whether the restriction existed on the 31 December 1993. The Court pointed out, in paragraph 92, that –

> "while it is, in principle, for the national court to determine the content of the legislation which existed on a date laid down by an EU measure, it is for the Court of Justice to provide guidance on interpreting the concept of EU law which constitutes the basis of a derogation under EU law for national legislation 'existing' on a particular date …"

The Court explained that the legislation concerning these restrictions must have formed part of the legal order of the Member State in question since 31 December 1993. However, the Court indicated that new legislation could be adopted after this date if it was identical to the previous legislation or if it was limited to reducing or eliminating an obstacle to the exercise of free movement of capital in the previous legislation. The Court stressed, in paragraph 94, that –

> "legislation based on an approach which differs from that of the previous law and establishes new procedures cannot be treated as legislation existing on that date".

Legislation Existing on 31 December 1993

CPP argued that Article 64 TFEU did not apply because the German legislation concerning pension funds did not come into play until 2002.

The Court pointed out that it was a matter for the national court to determine whether, because the legislation regarding pension funds was introduced after 31 December 1993, the situation of non-resident funds has become less advantageous than that of resident funds with regard to dividends paid to them by German companies, so that the restriction in the present case cannot be considered to have existed on that date. The Court indicated that if this was the case, the condition contained in Article 64 TFEU is not fulfilled.

Derogation from Article 63 TFEU

The Court noted that Article 64 TFEU set out an exhaustive list of capital movements to which Article 63(1) TFEU is liable not to apply (paragraph 100 of *College Pension Plan*) and, as a derogation from Article 63 TFEU, it had to be interpreted strictly.

The Court explained that portfolio investments are not included in the "direct investments" mentioned in Article 64(1) TFEU. The Court highlighted that CPP's shareholdings in the dividend distributing companies in Germany never exceeded 1%. Therefore, the Court concluded that the situation at issue did not involve "direct investments" within the meaning of Article 64(1) TFEU. However, the Court pointed out that the provision of pensions may fall within the concept of "financial services" within the meaning of Article 64(1) TFEU.

The Court stressed, in paragraphs 104 and 105, that –

> "the decisive criterion for the application of Article 64(1) TFEU is concerned with the causal link between the capital movements and the provision of financial services and not with the personal scope of the contested national measure or its relationship with the provider, rather than the recipient, of such services. The scope of that provision is defined by reference to the categories of capital movements which are capable of being subject to restrictions …
>
> the national measure must therefore relate to capital movements that have a sufficiently close link with the provision of financial services, namely a causal link between the movement of capital and the provision of financial services ...
>
> National legislation which, in applying to capital movements to or from third countries, restricts the provision of financial services thus falls within Article 64(1) TFEU …"

The Court concluded, in paragraphs108 and 109, that –

> "the acquisition of shareholdings by a pension fund and the dividends which it receives as a result serve the purpose, first and foremost, of preserving its assets and of guaranteeing the provisions constituted by the fund, through increased diversification and better spreading of risk, in order to ensure that it can meet its pension commitments to its insured persons. Those acquisitions of shareholdings and those dividends thus constitute, in the first place, a means by which a pension fund can honour its pension commitments and not a service that it provides to those insured persons …
>
> there is not a sufficiently close link in the form of a causal link … between the movement of capital referred to in the legislation at issue … relating to the receipt of dividends by a pension fund, and a provision of financial services, within the meaning of Article 64(1) TFEU".

The Court's Conclusion on Question 2

Article 64(1) TFEU did not apply in this case since the restriction cannot be considered to have existed since the 31 December 1993.

Analysis

The judgment in *College Pension Plan* follows the Court's earlier jurisprudence concerning free movement of capital. The Court applies the equal treatment principle from a host Member State perspective. Since Germany taxed dividend income paid to non-resident pension funds, the Court indicated that such non-resident funds were in a comparable situation to resident pension funds that also received dividends from German resident companies. However, Germany provided resident pension funds with a tax advantage which it failed to provide to non-resident funds.
The Court found that there was no justification for this disadvantageous tax treatment and consequently, the German rules breached the free movement of capital.

Preliminary Issue

As a preliminary issue in this case, Germany argued that the oral part of the procedure should be reopened because the Opinion of the Advocate General was based on findings of fact relating to German law which were incorrect. The Court dismissed this application, pointing out that the Court was not bound by the Opinion of the Advocate General or by the reasoning contained in that Opinion. The Court also highlighted that the Statute of the Court of Justice of the European Union made no provision for the parties to submit observations in response to the Opinion of an Advocate General.

The Court indicated, however, that it may order the oral part of the procedure to be reopened if it considered that it lacked the necessary information or where a party has, after close of the oral procedure, submitted a new fact which was likely to be decisive for the decision of the Court, or where the case had to be decided on the basis of an argument that had not been debated between the parties.

The Court also stressed that it is in principle required to base its consideration of national law on the description provided to it by the national court in the order for reference. In *College Pension Plan,* the Court determined that the order for reference contained sufficient information on German law for it to deliver a preliminary ruling on the EU law issues.

Concept of Restriction on the Free Movement of Capital

The Court applied its earlier jurisprudence in defining the concept of restriction on the free movement of capital. It pointed out that the measures prevented by Article 63 TFEU as restrictions, include those measures that a likely to discourage non-residents from making investments in a Member State or to discourage that Member State's residents from doing so in any other States. The Court made this pronouncement in a number of earlier cases, including *FII GLO.* [4]

Thus, in *College Pension Plan,* Germany's taxation of non-resident pension funds on dividend income received from German resident companies constituted a restriction on the free movement of capital because it amounted to a heavier tax burden than that imposed on resident pension funds receiving similar dividends. The Court noted that the same reasoning applied to the total or substantial exemption of dividends granted to resident pension funds which was denied to non-resident funds. Thus, the less favourable tax treatment of dividends paid to non-resident funds compared to the treatment of dividends to resident funds constituted a restriction on the free movement of capital.

Equal Treatment Test

In *College Pension Plan,* the Court applied the equal treatment test in a free movement of capital situation from a host Member State perspective. The Court compared the different tax treatment of resident and non-resident pension funds which received dividends from German resident companies in which the pension funds had made portfolio investments.

In this case, the tax treatment of a non-resident pension fund receiving dividends from Germany is compared with the tax treatment of a German resident pension fund receiving similar dividends. The Court noted that under the German legislation, pension funds are subject to two different sets of tax rules, in relation to dividends paid to them by German companies, resulting in dividends paid to non-resident funds receiving less favourable tax treatment than that applied to dividends paid to resident funds. This amounted to a restriction on the free movement of capital.

The Court pointed out that such a difference in treatment could be justified if the situations were not objectively comparable. In conducting this comparability analysis, the Court confirmed, in paragraph 65, that –

4 See *Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue ("FII GLO"),* C-446/04, ECLI:EU:C:2006:774, para. 64. For analysis of *FII GLO,* see Tom O'Shea, "Dividend Taxation Post-*Manninen:* Shifting Sands or Solid Foundations?" Tax Notes International, Mar. 5, 2007, 887-918, at p 888 et seq.

> "the comparability of a cross-border situation with an internal one must be examined having regard to the aim pursued by the national provisions at issue as well as their purpose and content".

The Court went on to apply its settled case law, in paragraph 66, that –

> "as soon as a Member State, either unilaterally or by way of a convention, imposes a charge to tax on the income not only of resident taxpayers but also of non-resident taxpayers from dividends which they receive from a resident company, the situation of those non-resident taxpayers becomes comparable to that of resident taxpayers".

Consequently, in *College Pension Plan*, since Germany imposed a withholding tax on non-resident pension funds that received dividends from German resident companies, such non-resident pension funds were placed in a comparable situation to that of resident pension funds. Both suffered economic double taxation of dividend income. Since both were in a comparable situation, any tax advantages granted to a resident pension fund in relation to that dividend income also had to be granted to a non-resident fund that was in a comparable situation, because such funds were entitled to equal treatment under the free movement of capital.

***Truck Center* Distinguished**

The Court distinguished the situation in *College Pension Plan* from that which existed in *Truck Center.*

The Court highlighted that in *Truck Center,* a cross-border interest payment was taxed via a withholding tax while a domestic interest payment was taxed as income under the corporation tax regime. This was not the situation in *College Pension Plan* since the withholding tax was effectively imposed only on non-resident funds as resident pension funds benefited from an off-set against their corporate income taxes.

It should be noted that *Truck Center* concerned an interest payment rather than a dividend payment. Consequently, there was no economic double taxation in play and the cross-border situation was not comparable to the domestic. However, the Court still had to determine whether the Belgian rules at issue amounted to a restriction on the freedom of establishment or free movement of capital. In the circumstances of the case, the headline rate of withholding tax (15%) was less than the headline rate of corporation tax (over 30%). Accordingly, the Court determined that the withholding tax did not constitute a restriction.

In *College Pension Plan*, paragraph 70, the Court explained that in *Truck Center* –

> "it nevertheless made clear, in paragraphs 43, 44 and 49 of that judgment, that the income at issue in the case which gave rise to that judgment was, in any

> event, subject to tax irrespective of whether it was received by a resident or non-resident taxable person, and that, moreover, the difference in taxation arrangements did not necessarily procure an advantage for resident recipients".

The Court concluded, in *College Pension Plan*, paragraph 73, that –

> "the difference in treatment at issue in the main proceedings cannot be justified by the difference in the situation of resident and non-resident pension funds in the light of the application of the different taxation arrangements".

Final thoughts

The judgment in *College Pension Plan* follows the Court's settled case law in relation to outbound dividend situations. Comparability of the cross-border situation is established since the rules of the host Member State (Germany) tax the outbound dividends in the same way as a payment of dividends to domestic pension funds in Germany. In such circumstances, the Court adopts the same approach that it adopted in its first "outbound dividend" case – *ACT IV GLO*. [5] In paragraph 68 of the *ACT IV GLO* judgment, the Court explains that –

> "However, once a Member State, unilaterally or by a convention, imposes a charge to income tax not only on resident shareholders but also on non-resident shareholders in respect of dividends which they receive from a resident company, the position of those non-resident shareholders becomes comparable to that of resident shareholders".

As noted earlier above, the Court applied this same reasoning in *College Pension Plan*, paragraph 66 and, quite recently, in *Sofina*, paragraph 47.[6]

Once comparability is established, a Member State cannot grant a tax advantage to a domestic fund and not make the same advantage available to a cross-border fund that is in a comparable situation.

The Court made this very clear in *Sofina*, where the French rules imposed a withholding tax on dividends paid to a Belgian company but exempted a domestic company from similar taxes if the recipient was loss-making.

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5 *Test Claimants in Class IV of the ACT Group Litigation v Commissioners of Inland Revenue ("ACT IV GLO")*, C-374/04, ECLI:EU:C:2006:773. For a detailed analysis, see Tom O'Shea, "Dividend Taxation Post-*Manninen:* Shifting Sands or Solid Foundations?" Tax Notes International, Mar. 5, 2007, 887-918, at p 903 et seq and 916.

6 *Sofina SA and others ("Sofina"),* C-575/17, ECLI:EU:C:2018:943. For analysis by this author, see Tom O'Shea, "*Sofina*: French Withholding Tax Rules Breached Free Movement of Capital, CJEU Says", Tax Notes International, Feb. 11, 2019, 649-652.

The Court noted in *Sofina*, paragraphs 28 and 29, that –

> "whereas the dividends paid to a non-resident company are subject to immediate and definitive taxation, the tax imposed on dividends paid to a resident company depends on whether the latter's financial year is net loss-making or net profit-making. Thus, where losses are made, the taxation of those dividends is not only deferred to a subsequent profit-making year, thus procuring a cash-flow advantage for the resident company, but is also thereby uncertain, since that tax will not be levied if the resident company ceases trading before becoming profitable ...
>
> the exclusion of a cash-flow advantage in a cross-border situation when it is granted in an equivalent situation on national territory constitutes a restriction on the free movement of capital".

Accordingly, the Court concluded in *Sofina*, paragraph 34, that –

> "the national legislation at issue in the main proceedings is liable to procure an advantage for loss-making resident companies, since it gives rise, at the very least, to a cash-flow advantage, or even an exemption in the event of that company ceasing trading, whereas non-resident companies are subject to immediate and definitive taxation irrespective of their results".

The French rules in *Sofina*, thus, amounted to a restriction on the free movement of capital contrary to Article 63 TFEU.

The *College Pension Plan* judgment demonstrates the consistency of the Court in dealing with outbound dividend situations. As in *Sofina*, the tax advantage granted in a domestic situation had to be extended to a comparable cross-border situation when the free movement of capital was exercised and there was no justification or derogation in play.