Euro Tax Flash from KPMG's EU Tax Centre

CJEU finds Spanish withholding tax in breach of EU law

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Key Summary:

On December 19, 2024, the Court of Justice of the European Union (CJEU or the Court) rendered its decision in case C-601/23. The case concerns the compatibility of the Spanish dividend withholding tax with EU law.

The Court found that Spain's withholding tax rules, which treat the withholding tax on dividends as a prepayment of CIT for resident companies (which can be reimbursed in the event of tax losses), but as a final levy for non-resident companies in similar circumstances, constitute an unjustified restriction on the free movement of capital.

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CJEU – Spain – Withholding tax on dividends – Reimbursement of withholding tax – Free movement of capital – Comparability

Background

Case C-601/23 concerns a UK-based company with no permanent establishment in Spain (the Plaintiff) that received a dividend of EUR 2.7 million from a company based in the Basque Country (Biscay). The payment was initially subject to a withholding tax rate of 19 percent but ultimately reduced to 10 percent under the Spain-UK double tax treaty.

Background

Based on Spanish legislation applicable at the time, the withholding tax levied represented a final tax for non-resident companies, with no available mechanism for reimbursement in the event that the recipient sustained losses in the relevant tax year. On the other hand, for a resident company subject to corporate income tax (CIT) in Biscay, the withholding tax constituted an advance payment on account of CIT, which only gave rise to the actual levying of the tax if that company has a positive tax base for the tax year in question. If the tax base was negative, the tax withheld would be reimbursed.

The Plaintiff argued that, as a loss-making company, it was unable to offset the tax withheld in Spain against its tax liabilities in the UK. In light of the difference in treatment compared to a local resident, the Plaintiff therefore argued that the impossibility to obtain a refund of the WHT paid was a breach of the free movement of capital guaranteed by Article 63 of the Treaty on the Functioning of the European Union ("TFEU").

The High Court of Justice of the Basque Country expressed doubts on whether the tax treatment of non-resident companies was compatible with EU law and referred the case to the CJEU for clarification.

CJEU decision

Admissibility

First with respect to the admissibility of the case, the CJEU recalled that, in principle, it is bound to give a ruling where the question submitted concerns the interpretation or the validity of a rule of EU law, unless it is obvious that the interpretation sought bears no relation to the actual facts of the main proceedings or its purpose, where the problem is hypothetical, or where the CJEU does not have the information necessary to give a useful answer to that question. Since none of these conditions applied in the present case, the request for a preliminary ruling was deemed admissible.

Existence of a restriction of the EU free movement of capital

CJEU decision

The CJEU assessed the existence of a restriction of the free movement of capital under Article 63 TFEU. In that regard, the CJEU recalled that a less favorable treatment by a Member State of dividends paid to non-resident companies, compared to the treatment of dividends paid to resident companies in a comparable situation, may deter companies established in other Member States to invest in companies in the first Member State and may consequently lead to a restriction of the free movement of capital.

In that respect, the CJEU noted that the Spanish rules may lead to an advantage for resident loss making companies. Dividends received by resident companies would be included in the assessment for corporate income tax, and in case of tax losses, taxation would be carried forward until a next positive financial year, which leads, at the very least, to a cash-flow advantage, or even an exemption if the company does not achieve any positive results in the future. Non-resident entities, on the other hand, are subject to immediate and definitive taxation, irrespective of their results. The CJEU therefore ruled that the Spanish tax rules, which treat the withholding tax on dividends as a payment on account of CIT for resident companies (which can be reimbursed in the event of tax losses), but as a final levy for non-resident companies in similar circumstances, lead to a difference in treatment.

The Court also rejected Spain's plea that the withholding tax rate applicable under the Spain – UK double tax treaty is lower (i.e., 10 percent) as compared to the general CIT rate applicable to dividends paid to resident entities, once included in the company's CIT base (i.e., 28 percent at the time). In the CJEU's view, this distinction does not mitigate the less favorable treatment applied to dividends paid to non-resident companies that are loss-making.

Moreover, the CJEU recalled that a restriction of a fundamental freedom cannot be regarded as compatible with EU law on the grounds of a potential existence of other advantages, nor on the ground that legislation does not discriminate between non-residents and residents in other situations.

The Court held that this difference in treatment of dividends according to the place of residence of the dividend receiving companies, which favors resident companies, may deter non-resident companies from investing in companies established in Biscay, and constitutes a restriction on the free movement of capital under Article 63 TFEU.

Existence of a justification for the restriction

The CJEU then assessed the existence of a justification for the restriction. The Court noted that it is settled case-law that a difference in treatment is only compatible with the free movement of capital if it concerns situations that are not objectively comparable or where it can be justified by an overriding reason in the public interest.

On the latter point, the CJEU held that the difference in treatment resulting from the rules at issue concerns situations that are objectively comparable. In that regard, the CJEU recalled that, once a Member State, either unilaterally or by way of a convention, levies a tax from both resident and non-resident taxpayers on the income from dividends received from a resident company, the situation of those non-resident taxpayers becomes comparable to that of resident taxpayers. This finding also applies to the present case.

The Provincial Council of Biscay argued that the difference in treatment could be justified by one of the following overriding reasons in the public interest:

1. the effective collection of tax;
2. the balanced allocation of the power of taxation between Member States and preventing the risk of losses being used twice;
3. maintaining the cohesion of the tax system.

The CJEU rejected the argument that the difference in treatment is justified by the effective collection of tax. The Court recalled that the restriction lies in the fact that, unlike loss-making resident companies, non-resident loss-making companies benefit neither from reimbursement of the withholding tax, nor from a potential deferral of taxation. In the Court's view, granting such a benefit to non-resident companies would eliminate the restriction and it would not undermine the achievement of the aim of the effective collection of tax.

The CJEU also denied the argument on the balanced allocation of the taxing rights between Member States and on preventing the risk of losses being used twice. The CJEU noted in that regard that, based on settled case-law, a Member State cannot rely on the preservation of a balanced allocation of taxing rights between Member States as a justification for the choice not to tax resident companies on domestic dividends, while taxing non-resident companies which receive such income. Furthermore, the CJEU noted that deferring the dividend withholding tax of loss-making non-resident companies, would not require the source Member State to waive its right to tax such income, but rather only defers such taxation until the non-resident entity becomes profitable in a subsequent year. With regard to the risk of losses being used twice, it is for the non-resident companies to provide proof to enable the tax authorities of the taxing Member State, to determine that the conditions to benefit from a deferral of taxation have been met.

Finally, the CJEU also rejected the argument based on maintaining the coherence of the tax system, as this requires the existence of a direct link between the tax advantage concerned and the offsetting of that advantage by a tax levy, which was not established in this case.

Consequently, the CJEU ruled that Article 63 TFEU precludes legislation under which dividends are subject to a withholding tax, where for resident companies the withholding tax on dividends serve a payment on account of CIT and is reimbursed in full if that company incurs losses in the respective financial year, whilst non-resident companies in a similar situation receive no reimbursement.

ETC Comment:

The CJEU decision is broadly in line with its previous case law on the taxation of outbound dividends.

This ruling opens the door for refund claims regarding withholding tax levied in Spain. Non-resident companies that were subject to withholding tax in Spain during open audit periods and that suffered tax losses during those fiscal years could now be entitled to a refund based on the principle of the free movement of capital and the ECJ's decision.

Should you have any queries, please do not hesitate to contact KPMG's EU Tax Centre, or, as appropriate, your local KPMG tax advisor.

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