Case C-284/09

European Commission

v

Federal Republic of Germany

(Failure of a Member State to fulfil obligations – Free movement of capital – Article 56 EC and Article 40 of the Agreement on the European Economic Area – Taxation of dividends – Dividends distributed to companies established in national territory and to companies established in another Member State or a State of the European Economic Area – Different treatment)

Summary of the Judgment

1. *Free movement of capital – Restrictions – Tax legislation – Corporation tax – Taxation of dividends – Receiving company's holding in the capital of the distributing company below the threshold laid down in Directive 90/435*

(Art. 56(1) EC; Council Directive 90/435, Art. 3(1)(a))

2. *International agreements – Agreement on the European Economic Area – Free movement of capital – National legislation taxing dividends distributed to a non-resident company more heavily than dividends distributed to a resident company – Not permissible*

(EEA Agreement, Art. 40)

1. A Member State fails to fulfil its obligations under Article 56(1) EC if it taxes dividends distributed to companies established in other Member States, where the threshold for a parent company's holding in the capital of its subsidiary laid down in Article 3(1)(a) of Directive 90/435 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, as amended by Directive 2003/123, is not reached, more heavily in economic terms than dividends distributed to companies established in its territory.

In respect of shareholdings not covered by Directive 90/435, it is indeed for the Member States to determine whether, and to what extent, economic double taxation or a series of charges to tax on distributed profits is to be avoided and, for that purpose, to establish, either unilaterally or by conventions concluded with other Member States, procedures intended to prevent or mitigate such economic double taxation or series of charges to tax. However, this does not of itself mean that they may impose measures that contravene the freedoms of movement guaranteed by the EC Treaty.

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 companies but also of non-resident companies from dividends which they receive from a resident company, the situation of those non-resident companies becomes comparable to that of resident companies. In such a case, in order for non-resident companies receiving dividends not to be subject to a restriction on the free movement of capital prohibited in principle by Article 56 EC, the State in which the distributing company is resident must ensure that, under the procedures laid down by its national law in order to prevent or mitigate a series of liabilities to tax or economic double taxation, non-resident companies are subject to the same treatment as resident companies.

Such a restriction is not justified by overriding reasons in the public interest. A justification connected with the need to safeguard the balanced allocation between the Member States of the power to tax may indeed be accepted, in particular, where the system in question is designed to prevent conduct capable of jeopardising the right of a Member State to exercise its powers of taxation in relation to activities carried on in its territory. However, where a Member State has chosen not to tax recipient companies established in its territory in respect of income of this kind, it cannot rely on the need to ensure a balanced allocation between the Member States of the power to tax in order to justify the taxation of recipient companies established in another Member State. A 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. Nor is such a measure justified by reasons connected with the coherence of the tax system. The argument that the tax advantage concerned is compensated by a tax disadvantage cannot succeed, since there is no direct link between the exemption from withholding tax on dividends distributed to resident companies and the taxation of those dividends, whether as income of the shareholders of those companies or on the occasion of a possible future taxable transaction.

(see paras 48, 56-57, 77-78, 83, 86, 92, 94, operative part 1)

2. A Member State fails to fulfil its obligations under Article 40 of the Agreement on the European Economic Area (EEA) if it taxes dividends distributed to companies established in Iceland and Norway more heavily in economic terms than dividends distributed to companies established in its territory.

While restrictions of the free movement of capital between nationals of States party to the EEA Agreement must be assessed in the light of Article 40 of and Annex XII to that agreement, those provisions have the same legal scope as the substantially identical provisions of Article 56 EC.

(see paras 96, 99, operative part 2)

JUDGMENT OF THE COURT (First Chamber)

20 October 2011 (*)

(Failure of a Member State to fulfil obligations – Free movement of capital – Article 56 EC and Article 40 of the Agreement on the European Economic Area – Taxation of dividends – Dividends distributed to companies established in national territory and to companies established in another Member State or a State of the European Economic Area – Different treatment)

In Case C?284/09,

ACTION under Article 226 EC for failure to fulfil obligations, brought on 23 July 2009,

European Commission, represented by R. Lyal and B.?R. Killmann, acting as Agents, with an address for service in Luxembourg, applicant,

v

Federal Republic of Germany, represented by M. Lumma and C. Blaschke, acting as Agents, and Professor H. Kube,

defendant,

THE COURT (First Chamber),

composed of A. Tizzano, President of the Chamber, M. Safjan, M. Ileši?, E. Levits (Rapporteur) and J.?J. Kasel, Judges,

Advocate General: E. Sharpston,

Registrar: B. Fülöp, Administrator,

having regard to the written procedure and further to the hearing on 9 December 2010,

having decided, after hearing the Advocate General, to proceed to judgment without an Opinion,

gives the following

Judgment

1 By its application the Commission of the European Communities asks the Court to declare that, by taxing dividends distributed to a company with its registered office in another Member State or in the European Economic Area (EEA) more heavily in economic terms than dividends distributed to a company with its registered office in its territory, the Federal Republic of Germany has failed to fulfil its obligations under Article 56 EC where the threshold for a parent company's holding in the capital of its subsidiary laid down in 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 1990 L 225, p. 6), as amended by Council Directive 2003/123/EC of 22 December 2003 (OJ 2004 L 7, p. 41) ('Directive 90/435'), is not reached, and under Article 40 of the Agreement on the European Economic Area of 2 May 1992 (OJ 1994 L 1, p. 3, 'the EEA Agreement'), in so far as the Republic of Iceland and the Kingdom of Norway are concerned.

Legal context

The EEA Agreement

2 Article 40 of the EEA Agreement provides:

'Within the framework of the provisions of this Agreement, there shall be no restrictions between the Contracting Parties on the movement of capital belonging to persons resident in [European Union] Member States or [European Free Trade Association (EFTA)] States and no discrimination based on the nationality or on the place of residence of the parties or on the place where such capital is invested. Annex XII contains the provisions necessary to implement this Article.'

European Union law

3 Article 3(1) of Directive 90/435 provides:

‘For the purposes of applying this Directive:

(a) the status of parent company shall be attributed at least to any company of a Member State which fulfils the conditions set out in Article 2 and has a minimum holding of 20% in the capital of a company of another Member State fulfilling the same conditions;

…

from 1 January 2007 the minimum holding percentage shall be 15%;

from 1 January 2009 the minimum holding percentage shall be 10%;

…’

4 Under Article 5(1) of Directive 90/435, profits which a subsidiary distributes to its parent company are exempt from withholding tax.

National legislation

Taxation of dividends generally

5 The German system of taxation of income from capital derives from the Law on Income Tax (Einkommensteuergesetz, BGBl. 2002 I, p. 4210, in the version published in BGBl. 2003 I, p. 179, ‘the EStG’) in conjunction, as regards the taxation of legal persons, with the Law on Corporation Tax (Körperschaftsteuergesetz, BGBl. 2002 I, p. 4144, ‘the KStG’). The relevant provisions, in the version applicable to the present case, were those set out in paragraphs 6 to 15 below.

6 Under Paragraph 20(1)(1) of the EStG:

‘Income from capital includes:

1. profit shares (dividends) … from shares in companies with limited liability, trading cooperatives, and mining associations which have the rights of a legal person. Other receipts also include covert distributions of profits. The receipts are not part of income in so far as they derive from distributions by a corporation for which amounts from the fiscal deposit account within the meaning of Paragraph 27 of the [KStG] are deemed to be used.’

7 Paragraph 43 of the EStG, ‘Income from capital with deduction of tax’, provides in subparagraph 1, first sentence, point 1, and third sentence:

‘In the case of the following domestic, and in the case of points 7(a) and 8 and the second sentence also foreign, income from capital, income tax is levied by deduction from the income from capital (tax on income from capital):

1. income from capital within the meaning of Paragraph 20(1)(1) and (2);

…

The tax is to be deducted notwithstanding Paragraphs 3(40) and 8b of the [KStG].’

8 Under Paragraph 44(1), first to third sentences, of the EStG, relating to the payment of tax on income from capital:

‘The person liable to pay the tax on income from capital, in the cases in Paragraph 43(1), first sentence, [point 1] … is the creditor of the income from capital. The tax on income from capital arises at the time when the creditor receives the income from capital. At that time, in the cases in Paragraph 43(1), first sentence, points 1 to 4 … the debtor of the income from capital … must deduct the tax, on account of the creditor of the income from capital.’

9 Calculation of the tax on income from capital is governed by Paragraph 43a(1)(1) of the EStG, which reads as follows:

‘The tax on income from capital amounts to

1. in the cases in Paragraph 43(1), first sentence, [point 1], …

25% of the income from capital; …’

10 In the case of dividends paid by a subsidiary, Paragraph 8b(1), first sentence, of the KStG provides that they are not to be taken into account in calculating the income of the parent company.

Taxation of dividends distributed to a company whose registered office is in Germany

11 As regards the taxation of dividends distributed to a company whose registered office is in Germany, Paragraph 31(1), first sentence, of the KStG refers to the relevant provisions of the EStG.

12 Paragraph 36(2)(2) and (4), second sentence, of the EStG, dealing with the arising and discharging of income tax, reads as follows:

‘(2) Set off against income tax are:

…

2. income tax levied by means of tax deduction, in so far as it is due on … receipts which, under … Paragraph 8b(1) and (6), second sentence, of the [KStG], are not taken into account when ascertaining income, and reimbursement has not been applied for or carried out. The income tax levied by tax deduction is not set off if the certificate specified in Paragraph 45a(2) or (3) has not been produced. …

…

(4) … If, after the calculation, there is an excess in favour of the taxpayer, this is paid to the taxpayer after notification of the tax assessment.’

Taxation of dividends distributed to a company whose registered office is not in Germany

13 Companies which have neither their management nor their registered office in Germany or do not have unlimited liability to tax in Germany are regarded, under Paragraph 2 of the KStG, as having limited liability to tax in respect of income received in Germany.

14 Under Paragraph 32(1)(2) of the KStG, where the person receiving the income has limited tax liability in Germany, corporation tax in respect of income subject to withholding tax is definitively paid by the withholding tax.

15 Paragraph 43b of the EStG provides that, on application by the taxpayer, tax on income from capital will not be charged where the holding of a parent company established in a Member State other than the Federal Republic of Germany in the capital of its subsidiary reaches the

threshold provided for in Article 3(1)(a) of Directive 90/435.

Conventions for the prevention of double taxation

16 The conventions for the prevention of double taxation concluded by the Federal Republic of Germany with all the other Member States and with the Republic of Iceland and the Kingdom of Norway include provisions relating to the setting off of withholding tax charged in Germany against the amount of tax due in the Member State in which the parent company is established. The amount of the tax credit cannot exceed the proportion of tax, calculated before the setting off, which relates to the income from Germany, and the conventions do not provide for the reimbursement of any credit balance resulting from the difference between the burden of tax in the Member State concerned and the withholding tax in Germany.

Pre-litigation procedure

17 By letter of formal notice of 12 October 2005, the Commission drew the attention of the Federal Republic of Germany to the doubts it entertained as to the compatibility with Article 56 EC and Article 40 of the EEA Agreement of the German system of taxation of dividends, in that it gave preferential tax treatment to resident companies in receipt of dividends, compared to companies in receipt of dividends established in another Member State or in a State party to the EEA Agreement.

18 The German Government replied to the letter of formal notice by letter of 21 December 2005.

19 On 27 June 2007 the Commission sent the Federal Republic of Germany a reasoned opinion in which it stated that it regarded it as incompatible with Article 56 EC that the combined effect of any national withholding tax and national income tax for domestic dividends led to lower taxation than the withholding tax on dividends leaving the country.

20 By letter of 28 July 2007, the German Government pointed out a discrepancy between the letter of formal notice, which was based on an incorrect account of German tax law in so far as it considered that resident parent companies were not under an obligation to pay the withholding tax on dividends, and the reasoned opinion, which stated correctly that German shareholders also had to pay the withholding tax, but concluded, differently from the letter of formal notice, that the infringement of the free movement of capital lay in the discharging effect of the withholding tax for parent companies established in Member States other than the Federal Republic of Germany or in States party to the EEA Agreement.

21 In reply to that letter, the Commission on 28 November 2007 sent the Federal Republic of Germany a supplementary letter of formal notice, in which it stated that, in its opinion, the substantive content of the pre-litigation procedure was not affected by the incorrect description of German tax law. It noted that, since German shareholders benefit from the setting off of withholding tax against corporation tax whereas, for companies established in other Member States or in States party to the EEA Agreement, the withholding tax has a discharging effect, those companies are subject to a greater tax burden on dividends.

22 As it did not accept the German Government’s request for an extension of time to reply to the supplementary letter of formal notice, the Commission on 28 February 2008 issued a supplementary reasoned opinion.

23 The Federal Republic of Germany replied to the supplementary reasoned opinion by letter of 30 April 2008, informing the Commission that it intended to take all necessary measures to comply

with the supplementary reasoned opinion.

24 Since the Commission found that, at the end of the two-month period allowed in the supplementary reasoned opinion, the Federal Republic of Germany had not amended its tax laws to comply with the opinion and ensure equal treatment of resident and non-resident companies, it brought the present action.

The action

Arguments of the parties

25 The Commission submits that the Federal Republic of Germany has infringed the free movement of capital enshrined in Article 56 EC and Article 40 of the EEA Agreement by removing the economic burden linked to tax on income from capital, deducted at source on distributions of dividends, by granting only to parent companies whose management and registered office are in its territory the possibility of having the withholding tax set off or reimbursed, without however, by domestic measures or on the basis of double taxation conventions concluded with the other Member States of the European Union or with the Republic of Iceland or the Kingdom of Norway, allowing parent companies established in those States to enjoy such tax advantages.

26 Parent companies established in Germany and those established in other Member States or in States party to the EEA Agreement are, in the Commission's view, in an objectively comparable situation. The Federal Republic of Germany has chosen to prevent a series of economic charges to tax on distributed profits, but only parent companies whose registered office and management are situated in national territory ultimately escape the economic burden linked with the payment of withholding tax, since they can not only set that tax off in full against their corporation tax but also obtain a reimbursement if the income tax to be paid is less than the withholding tax deducted, so that in reality they do not pay any tax on the dividends distributed to them. By contrast, parent companies established in other Member States or in States party to the EEA Agreement do not have the possibility of entirely avoiding the economic burden linked to the withholding tax, which, once deducted, is regarded as definitively paid.

27 The Commission explains that its action is limited to payments of dividends to capital companies, and that it is not material to compare the overall tax burden on dividends received by natural persons and partnerships in Germany and by capital companies abroad, as the situations in question are different.

28 According to the Commission, where a Member State grants advantages in connection with the taxation of dividends, including advantages such as set-off or reimbursement which have the economic effect of neutralising tax previously deducted at source, those advantages cannot be limited to recipients of dividends who are established in national territory and must extend to recipients established in other Member States or in States party to the EEA Agreement.

29 As regards the possible effect of double taxation conventions, the Commission submits, first, that the mere reduction, provided for in such conventions, of the rate of withholding tax for payments of dividends to parent companies established in other Member States or in States party to the EEA Agreement does not in itself give rise to complete economic equal treatment, as it is not equivalent to the complete economic exemption from withholding tax enjoyed, by contrast, by parent companies established in Germany.

30 Secondly, the methods of set-off laid down in the double taxation conventions concluded by the Federal Republic of Germany at most contribute to mitigating double taxation for parent companies not established in Germany, and do not allow full economic exemption to be obtained

in all cases, since the obligation to reduce the tax is limited to a maximum amount capable of being set off.

31 The Commission further observes that the fact that non-resident parent companies are not subject to business tax does not constitute a tax advantage, since, even if such an advantage existed, because of its different character it would not suffice to compensate the unfavourable tax treatment resulting from the definitive nature of the tax on income from capital deducted at source precisely from those parent companies. The reason why a parent company established in another Member State or a State party to the EEA Agreement is not obliged to pay business tax is that it does not carry on an economic activity in a German municipality and there is nothing to tax.

32 The Commission submits, finally, that the tax system at issue cannot be justified by the need to maintain a balanced allocation of the power to tax between the Member States or on grounds of the coherence of the German tax system.

33 The Federal Republic of Germany criticises the Commission for examining in isolation the exemption of interposed capital companies even though, since 2001, Germany has applied a partial income system that divides the taxation of dividends into two stages. Thus, in the first stage of that partial taxation, the company distributing the dividends is subject to a definitive non-deductible corporation tax, at the rate of 15% as from 1 January 2008, while in the second stage of partial taxation the final shareholder receiving the dividend is taxed in such a way that full taxation of the profit distributed is obtained by adding that tax to the partial taxation in the first stage. Consequently, a single whole charge to tax is obtained by means of two partial charges to tax, and the interposed shareholding companies are exempted in order to avoid over-taxation. The decision not to tax dividends paid to a resident company owning a shareholding, in accordance with Paragraph 8b of the KStG, should not therefore be regarded as a decision not to exercise the power to tax dividends, since that power is exercised by means of the overall multi-stage system.

34 That principle of a single whole tax charge on the profit generated in Germany and distributed applies where the profit does not leave national territory as well as in cross-border cases. However, for the tax charge on dividends imposed by the Federal Republic of Germany to be equal in domestic and cross-border situations, it is necessary in the latter case to bring the second stage of taxation forward, since the distribution of dividends by the foreign parent company to its foreign shareholders is outside the tax jurisdiction of the Federal Republic of Germany. Yet each Member State has the right to tax profits generated in its territory, in accordance with the principle of allocation of powers and territoriality.

35 The Federal Republic of Germany concedes that it treats resident and non-resident capital companies differently when they receive dividends from resident companies, since only resident companies may benefit from the tax exemption under Paragraph 8b of the KStG.

36 That difference of treatment is purely formal, however, and does not give rise to discrimination against parent companies established in another Member State or a State party to the EEA Agreement.

37 First, companies established in Germany and companies with their registered office in other Member States or States party to the EEA Agreement are not in a comparable situation with respect to the objective of Paragraph 8b of the KStG, which is to avoid over-taxation of dividends in Germany when applying the system of partial taxation of income. Where dividends are distributed to a company established in another Member State or a State party to the EEA Agreement, no risk of over-taxation arises.

38 Secondly, foreign investors are not deterred by German tax law from investing in the capital

of undertakings established in Germany, since, subject to a reduction on the basis of a double taxation convention, the burden of German tax borne by dividends paid to non-resident recipients is fundamentally the same as that borne by dividends paid to resident recipients.

39 Additional taxation takes place, in the case of the cross-frontier distribution of dividends, only by the action of the State of residence of the recipient, that being the result of the juxtaposition of different fiscal legislation.

40 Pursuant to the conventions for the prevention of double taxation in connection with income and corporation tax concluded with all the other Member States of the European Union and with the Republic of Iceland and the Kingdom of Norway, the Federal Republic of Germany limits itself to deducting at source a tax on dividends, at a rate usually of 10% or 15%. Having regard to those conventions, Germany actually taxes dividends paid to non-resident recipients much less heavily than those paid to resident recipients.

41 Moreover, the double taxation conventions provide that the risk of double taxation is to be avoided by setting off the withholding tax deducted in Germany against tax in the State of establishment of the company receiving the dividends.

42 Finally, the Federal Republic of Germany observes that, while distributions of dividends to resident companies are not subject to corporation tax, those dividends are taken into account in calculating the business tax payable by those companies under the law on that tax. By contrast, dividends distributed to foreign companies are not subject to business tax.

43 In the alternative, the Federal Republic of Germany submits that the German system of tax on dividends is, in any event, justified by overriding reasons in the public interest, in particular the need to preserve a balanced allocation of the power to tax, corresponding to the principle of territoriality, and the need to maintain the coherence of the tax system.

Findings of the Court

Infringement of Article 56(1) EC

– Existence of a restriction of the free movement of capital

44 According to the settled case-law of the Court, although direct taxation falls within their competence, the Member States must none the less exercise that competence consistently with European Union law (see, inter alia, Case C?374/04 *Test Claimants in Class IV of the ACT Group Litigation* [2006] ECR I?11673, paragraph 36; Case C?379/05 *Amurta* [2007] ECR I?9569, paragraph 16; Case C?540/07 *Commission* v *Italy* [2009] ECR I?10983, paragraph 28; and Case C?487/08 *Commission* v *Spain* [2010] ECR I?0000, paragraph 37).

45 In particular, it is for each Member State to organise, in compliance with European Union law, its system for taxing distributed profits and, in that context, to define the tax base and the tax rate which apply to the shareholder receiving them (see, inter alia, *Test Claimants in Class IV of the ACT Group Litigation*, paragraph 50; Case C?446/04 *Test Claimants in the FII Group Litigation* [2006] ECR I?11753, paragraph 47; Case C?194/06 *Orange European Smallcap Fund* [2008] ECR I?3747, paragraph 30; and Case C?128/08 *Damseaux* [2009] ECR I?6823, paragraph 25).

46 It must also be noted that, in the absence of any unifying or harmonising measures at European Union level, the Member States retain the power to define, by conventions or unilaterally, the criteria for allocating their powers of taxation, particularly with a view to eliminating double taxation (Case C?336/96 *Gilly* [1998] ECR I?2793, paragraphs 24 and 30; Case C?307/97 *Saint-Gobain ZN*

[1999] ECR I?6161, paragraph 57; *Amurta*, paragraph 17; *Commission* v *Italy*, paragraph 29; and *Commission* v *Spain*, paragraph 38).

47 As appears particularly from the third recital in the preamble to Directive 90/435, the aim of that directive is, by the introduction of a common system of taxation, to eliminate any disadvantage to cooperation between companies of different Member States as compared with cooperation between companies of the same Member State and thereby to facilitate the grouping together of companies at European Union level (*Test Claimants in the FII Group Litigation*, paragraph 103; *Amurta*, paragraph 18; and *Commission* v *Spain*, paragraph 39).

48 In respect of shareholdings not covered by Directive 90/435, it is for the Member States to determine whether, and to what extent, economic double taxation or a series of charges to tax on distributed profits is to be avoided and, for that purpose, to establish, either unilaterally or by conventions concluded with other Member States, procedures intended to prevent or mitigate such economic double taxation or series of charges to tax. However, this does not of itself mean that the Member States are entitled to impose measures that contravene the freedoms of movement guaranteed by the EC Treaty (see *Test Claimants in Class IV of the ACT Group Litigation*, paragraph 54; *Amurta*, paragraph 24; *Commission* v *Italy*, paragraph 31; and *Commission* v *Spain*, paragraph 40).

49 In the present case, it is common ground that the German legislation levies withholding tax on dividends distributed by a company established in Germany either to companies resident in Germany or to companies established in another Member State. However, dividends distributed to companies established in Germany are not taken into account in calculating those companies' income, in accordance with the first sentence of Paragraph 8b(1) of the KStG, and have the benefit of a tax credit relating to the withholding tax deducted. Moreover, in accordance with Paragraph 36(2) and (4) of the EStG, that tax credit is reimbursed to the taxpayer to the extent that the amount of income tax to be paid is less than the amount of the tax credit. It follows that resident companies receiving dividends suffer no tax burden as a result of the withholding tax.

50 On the other hand, as regards dividends paid to companies established in another Member State, where the parent company's holding in the capital of the subsidiary does not reach the threshold provided for in Article 3(1)(a) of Directive 90/435, the withholding tax is regarded by German tax law as definitively levied.

51 It is not disputed that the German tax legislation thus treats dividends differently, depending on whether they are distributed to resident or non-resident companies.

52 The Federal Republic of Germany submits, however, that the companies receiving dividends are not in a comparable situation from the point of view of the tax legislation at issue, and that the tax burden on dividends paid to companies established in another Member State is no greater than that on dividends distributed to resident companies.

53 First, it must be ascertained whether, having regard to the aim of that legislation, which, according to the Federal Republic of Germany, is to prevent over-taxation in Germany of distributed profits, companies in receipt of dividends are in comparable situations depending on whether or not they are resident in Germany.

54 It is clear that the objective of preventing over-taxation in Germany of distributed profits is achieved by removing the application of a series of charges to tax on dividends distributed to resident companies, in the manner described in paragraph 49 above.

55 It follows from the case-law that, from the point of view of measures laid down by a Member

State in order to prevent or mitigate the imposition of a series of charges to tax on, or the economic double taxation of, profits distributed by a resident company, resident companies receiving dividends are not necessarily in a situation which is comparable to that of companies receiving dividends which are resident in another Member State (see, to that effect, Case C?170/05 *Denkavit Internationaal and Denkavit France* [2006] ECR I?11949, paragraph 34; *Amurta*, paragraph 37; *Commission* v *Italy*, paragraph 51; and *Commission* v *Spain*, paragraph 50).

56 However, 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 companies but also of non-resident companies from dividends which they receive from a resident company, the situation of those non-resident companies becomes comparable to that of resident companies (see, to that effect, *Test Claimants in Class IV of the ACT Group Litigation*, paragraph 68; *Denkavit Internationaal and Denkavit France*, paragraph 35; *Amurta*, paragraph 38; *Commission* v *Italy*, paragraph 52; and *Commission* v *Spain*, paragraph 51).

57 It is solely because of the exercise by that State of its power of taxation that, irrespective of any taxation in another Member State, a risk of a series of charges to tax or economic double taxation may arise. In such a case, in order for non?resident companies receiving dividends not to be subject to a restriction on the free movement of capital prohibited in principle by Article 56 EC, the State in which the company making the distribution is resident is obliged to ensure that, under the procedures laid down by its national law in order to prevent or mitigate a series of liabilities to tax or economic double taxation, non-resident companies are subject to the same treatment as resident companies (see *Test Claimants in Class IV of the ACT Group Litigation*, paragraph 70; *Amurta*, paragraph 39; *Commission* v *Italy*, paragraph 53; and *Commission* v *Spain*, paragraph 52).

58 In the present case, the Federal Republic of Germany clearly chose to exercise its power of taxation over dividends distributed to companies resident in other Member States. Non-resident companies in receipt of those dividends thus find themselves in a situation comparable to that of resident companies as regards the risk of a series of charges to tax on dividends distributed by resident companies, so that non-resident recipient companies cannot be treated differently from resident recipient companies (*Commission* v *Spain*, paragraph 53).

59 That finding is not invalidated by the argument of the Federal Republic of Germany that resident and non-resident companies in receipt of dividends are not in a comparable situation, in that only profits redistributed by the former are liable to suffer over-taxation in Germany, since Germany can tax only the income of the shareholders of those companies who reside in that Member State.

60 Apart from the fact that it cannot be ruled out that a company resident in a Member State other than the Federal Republic of Germany may have shareholders who are resident in Germany, comparing the tax burden on dividends paid to non-resident companies with the overall tax burden on dividends where a resident company in receipt of dividends redistributes them to its resident shareholders amounts to comparing systems and situations which are not comparable, namely, on the one hand, natural persons in receipt of national dividends and their income tax arrangements and, on the other, capital companies in receipt of dividends leaving the country and the withholding tax levied by the Federal Republic of Germany (see, to that effect, *Commission* v *Italy*, paragraph 43).

61 Secondly, in order to show that the tax burden on dividends paid to companies established in another Member State is no greater than that on dividends distributed to resident companies, the Federal Republic of Germany refers to the double taxation conventions concluded with all the

Member States and to the fact that, unlike non-resident companies, resident companies are subject to business tax in Germany.

62 As regards the effect of double taxation conventions, the Court has indeed held that it cannot be ruled out that a Member State may succeed in ensuring compliance with its obligations under the Treaty by concluding a convention for the avoidance of double taxation with another Member State (see, to that effect, *Test Claimants in Class IV of the ACT Group Litigation*, paragraph 71; *Amurta*, paragraph 79; *Commission* v *Italy*, paragraph 36; and *Commission* v *Spain*, paragraph 58).

63 However, it is necessary for that purpose that the application of such a convention should allow the effects of the difference in treatment under national legislation to be compensated for (see *Commission* v *Italy*, paragraph 37, and *Commission* v *Spain*, paragraph 59).

64 According to the information provided by the Federal Republic of Germany, pursuant to the double taxation conventions concluded with the other Member States, Germany limits itself to deducting at source a tax on dividends at the rate usually of 10% or 15%, tax deducted at source in excess of that limit being reimbursed to the shareholder under national law.

65 However, as the Commission rightly submits, the mere reduction of the rate of withholding tax levied on distributions of dividends to companies established in another Member State cannot in itself compensate for the effects of the different treatment introduced by national tax legislation, in that it is not equivalent to the neutralisation of the economic burden of the withholding tax, in the manner described in paragraph 49 above, that companies established in Germany benefit from.

66 The Federal Republic of Germany further submits that the double taxation conventions provide that the risk of double taxation is to be avoided by setting the withholding tax off against the tax due in the State of establishment. According to the Commission, whose statements are not challenged by the defendant Member State, those conventions provide that the obligation concerning setting off is limited to a maximum amount that may be set off.

67 It must be observed in this respect that the application of the set-off method should enable the tax on dividends deducted in Germany to be set off in full against the tax payable in the State of establishment of the recipient company, so that, if the dividends received by that company were ultimately taxed more heavily than the dividends paid to companies established in Germany, that heavier tax burden could no longer be attributed to the Federal Republic of Germany, but to the State of establishment of the recipient company which exercised its power of taxation (see, to that effect, *Commission* v *Spain*, paragraph 60).

68 Consequently, the difference in treatment may be neutralised by that method of set-off only where the dividends from Germany are sufficiently taxed in the other Member State. If those dividends are not taxed, or are not sufficiently taxed, the amount of tax deducted in Germany or a part thereof cannot be set off (see *Commission* v *Italy*, paragraph 38, and *Commission* v *Spain*, paragraph 62).

69 It should also be pointed out that the decision to tax income from Germany in the other Member State, or the choice of the level at which it is to be taxed, depends not on the Federal Republic of Germany but on the tax rules laid down by the other Member State (*Commission* v *Spain*, paragraph 64).

70 The Federal Republic of Germany cannot therefore claim that the setting off of the tax paid in Germany against the tax payable in the other Member State, pursuant to the double taxation conventions, allows in every case the neutralisation of the difference of treatment resulting from

the application of the provisions of national tax legislation or of those conventions whose effect is to reduce the rate of the withholding tax (see also *Commission* v *Italy*, paragraph 39, and *Commission* v *Spain*, paragraph 64).

71 As regards, finally, the Federal Republic of Germany's argument that companies in receipt of dividends which are established in another Member State are not required to pay business tax, which companies in receipt of dividends established in Germany are subject to, it suffices to point out that, in accordance with the Court's case-law, unfavourable tax treatment contrary to a fundamental freedom cannot be regarded as compatible with European Union law because of the existence of other advantages, even assuming that such advantages exist (see, to that effect, Case C?35/98 *Verkooijen* [2000] ECR I?4071, paragraph 61; *Amurta*, paragraph 75; and Case C?233/09 *Dijkman and Dijkman-Lavaleije* [2010] ECR I?0000, paragraph 41).

72 It must therefore be concluded, in the light of the above observations, that the different treatment of dividends depending on whether they are distributed to resident or non-resident companies, as established by the German tax legislation, is liable to deter companies established in other Member States from making investments in Germany, and is also such as to constitute an obstacle to the raising of capital by resident companies from companies established in other Member States.

73 Consequently, that legislation constitutes a restriction of the free movement of capital, which is prohibited in principle by Article 56(1) EC.

– Justification of the restriction of the free movement of capital

74 In accordance with settled case-law, national measures restricting the free movement of capital may be justified by overriding reasons in the public interest, provided that they are appropriate to secure the attainment of the objective which they pursue and do not go beyond what is necessary in order to attain it (Case C?112/05 *Commission* v *Germany* [2007] ECR I?8995, paragraphs 72 and 73, and *Dijkman and Dijkman-Lavaleije*, paragraph 49).

75 In this respect, the Federal Republic of Germany submits, first, that the German tax legislation on the taxation of dividends, which aims to establish a single whole charge to tax in both domestic and cross-border situations, is justified by the need to ensure a balanced allocation of the power to tax, linked to the principle of territoriality, according to which each Member State is entitled to tax profits generated in its territory. Only the application of withholding tax enables the Federal Republic of Germany to ensure that dividends distributed on the basis of income produced by an economic activity in its territory are subject, once and in their entirety, to German tax.

76 The Federal Republic of Germany observes, moreover, that it follows from the case-law of the Court, in particular from *Test Claimants in Class IV of the ACT Group Litigation*, paragraph 59, and Case C?182/08 *Glaxo Wellcome* [2009] ECR I?8591, paragraph 83, that to require the State in which the company making the distribution is resident to ensure that profits distributed to a non-resident shareholder are not liable to a series of charges to tax or to economic double taxation would in fact mean that that State would have to abandon its right to tax a profit generated by an economic activity carried on in its territory.

77 It must be recalled here that a justification connected with the need to safeguard the balanced allocation between the Member States of the power to tax may be accepted, in particular, where the system in question is designed to prevent conduct capable of jeopardising the right of a Member State to exercise its powers of taxation in relation to activities carried on in its territory (see Case C?347/04 *Rewe Zentralfinanz* [2007] ECR I?2647, paragraph 42; Case C?231/05 *Oy AA* [2007] ECR I?6373, paragraph 54; *Amurta*, paragraph 58; and Case C?303/07 *Aberdeen Property Fininvest Alpha*

[2009] ECR I?5145, paragraph 66).

78 However, it also follows from the Court’s case-law that, where a Member State has chosen not to tax recipient companies established in its territory in respect of income of this kind, it cannot rely on the argument that there is a need to ensure a balanced allocation between the Member States of the power to tax in order to justify the taxation of recipient companies established in another Member State (*Amurta*, paragraph 59, and *Aberdeen Property Fininvest Alpha*, paragraph 67).

79 Although the Federal Republic of Germany submits that Paragraph 8b of the KStG should not be regarded as a materialisation of its decision not to exercise its power to tax dividends, it is common ground that companies established in Germany benefit, in the case of dividends distributed by resident companies, from a complete neutralisation of the effects of the deduction at source.

80 It is true that the Court has held that to require the State in which the company making the distribution is resident to ensure that profits distributed to a non-resident shareholder are not liable to a series of charges to tax or to economic double taxation, either by exempting those profits from tax at the level of the company making the distribution or by granting the shareholder a tax advantage equal to the tax paid on those profits by the company making the distribution, would in fact mean that that State would have to abandon its right to tax a profit generated by an economic activity carried on in its territory (see *Test Claimants in Class IV of the ACT Group Litigation*, paragraph 59, and *Glaxo Wellcome*, paragraph 83).

81 In the present case, however, the exemption from withholding tax or the tax advantage corresponding to the withholding tax deducted by the Federal Republic of Germany, if granted to companies established in another Member State, would not in fact mean that the Federal Republic of Germany would have to waive its right to tax income generated by an economic activity carried on in its territory. The dividends distributed by resident companies have already been taxed in the hands of the distributing companies as profits realised by them.

82 An exemption from withholding tax or the grant of a tax advantage corresponding to the withholding tax deducted by the Federal Republic of Germany would indeed entail a reduction of its tax revenue.

83 However, in accordance with settled case-law of the Court, a 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 (see, inter alia, Case C?319/02 *Manninen* [2004] ECR I?7477, paragraph 49 and the case-law cited).

84 The Federal Republic of Germany submits, secondly, that the system of taxing dividends is justified on grounds relating to the coherence of the tax system. The tax advantage granted by Paragraph 8b of the KStG is compensated by a tax disadvantage, namely the taxation of the shareholders. Even where the profits are not distributed to shareholders, the second stage of taxation is carried out in Germany.

85 On this point, it should be recalled that the Court has already acknowledged that the need to maintain the coherence of a tax system can justify a restriction on the exercise of the freedoms of movement guaranteed by the Treaty (Case C?204/90 *Bachmann* [1992] ECR I?249, paragraph 28; *Manninen*, paragraph 42; Case C?418/07 *Papillon* [2008] ECR I?8947, paragraph 43; and *Glaxo Wellcome*, paragraph 77).

86 For an argument based on such a justification to succeed, however, the Court requires there

to be a direct link between the tax advantage concerned and the compensating of that advantage by a particular tax levy, with the direct nature of that link falling to be examined in the light of the objective pursued by the rules in question (*Papillon*, paragraph 44, and *Glaxo Wellcome*, paragraph 78).

87 In the present case, in the context of the tax legislation at issue, the neutralisation of the effects of the withholding tax levied on the dividends distributed to a resident company is not subject to the two conditions that the dividends are redistributed by that company and that their taxation in the hands of the shareholders of that company compensates for the exemption in economic terms from the withholding tax.

88 As follows from the statement of reasons for the tax legislation at issue, set out in the defence of the Federal Republic of Germany, one of the aims of the system of partial taxation of income is to promote the reinvestment of operating profits in the undertaking and thereby to improve the self-financing of undertakings. Such a system of partial taxation is intended in particular to promote the retention of profits within the company and to avoid their being distributed to shareholders in the form of dividends.

89 Since the second stage of taxation takes place only if the profit has been distributed to the shareholders in the form of dividends, the system makes the accumulation of profits within the company more advantageous in tax terms than their distribution to the shareholders.

90 In so far as avoiding the second stage of taxation may be regarded as consistent with the objective of that tax scheme, which is to promote the accumulation of profits within the recipient company over their distribution to shareholders in the form of dividends, it cannot be considered that the advantage consisting in an exemption from withholding tax on dividends distributed to a resident company is in all cases compensated by the taxation of those profits in so far as they constitute income of the shareholders of the recipient company.

91 The argument of the Federal Republic of Germany that, even where the recipient company's profits are not distributed to the shareholders, the second stage of taxation none the less takes place later, in that a taxable transaction necessarily occurs in the future, cannot be accepted. Even supposing that that is the case, possible postponed taxation is not capable of justifying an immediate exemption from withholding tax on dividends distributed to resident companies.

92 Consequently, there is no direct link within the meaning of the case-law cited in paragraph 86 above between the exemption from withholding tax on dividends distributed to resident companies and the taxation of those dividends, whether as income of the shareholders of the companies or on the occasion of a possible future taxable transaction.

93 It follows that the restriction of the free movement of capital resulting from the tax legislation at issue cannot be justified on the grounds relied on by the Federal Republic of Germany.

94 It follows from all the foregoing that, by taxing dividends distributed to companies established in other Member States, where the threshold for a parent company's holding in the capital of its subsidiary laid down in Article 3(1)(a) of Directive 90/435 is not reached, more heavily in economic terms than dividends distributed to companies established in its territory, the Federal Republic of Germany has failed to fulfil its obligations under Article 56(1) EC.

Infringement of Article 40 of the EEA Agreement

95 One of the principal aims of the EEA Agreement is to provide for the fullest possible realisation of the free movement of goods, persons, services and capital within the whole EEA, so

that the internal market established within the European Union is extended to the EFTA States. From that angle, several provisions of the agreement are intended to ensure that it receives as uniform an interpretation as possible throughout the EEA (see Opinion 1/92 [1992] ECR I-2821). It is for the Court, in that context, to ensure that the rules of the EEA Agreement which are identical in substance to those of the Treaty are interpreted uniformly within the Member States (Case C?452/01 *Ospelt and Schlössle Weissenberg* [2003] ECR I?9743, paragraph 29, and *Commission* v *Italy*, paragraph 65).

96 It follows that, while restrictions of the free movement of capital between nationals of States party to the EEA Agreement must be assessed in the light of Article 40 of and Annex XII to that agreement, those provisions have the same legal scope as the substantially identical provisions of Article 56 EC (see Case C?521/07 *Commission* v *Netherlands* [2009] ECR I?4873, paragraph 33, and *Commission* v *Italy*, paragraph 66).

97 As found in paragraph 49 above, companies in receipt of dividends established in Germany suffer no tax burden as a result of the withholding tax on the dividends distributed to them by their resident subsidiaries.

98 As regards dividends paid to companies established in Iceland and Norway, the withholding tax is regarded in German law as having been levied definitively.

99 Consequently, and for the same reasons as those set out in connection with the consideration of the application from the point of view of Article 56(1) EC, it must be found that, by taxing dividends distributed to companies established in Iceland and Norway more heavily in economic terms than dividends distributed to companies established in its territory, the Federal Republic of Germany has failed to fulfil its obligations under Article 40 of the EEA Agreement.

Costs

100 Under Article 69(2) of the Rules of Procedure, the unsuccessful party is to be ordered to pay the costs if they have been applied for in the successful party’s pleadings. Since the Commission has applied for costs and the Federal Republic of Germany has been unsuccessful, the latter must be ordered to pay the costs.

On those grounds, the Court (First Chamber) hereby:

1. **Declares that, by taxing dividends distributed to companies established in other Member States, where the threshold for a parent company’s holding in the capital of its subsidiary laid down in Article 3(1)(a) of 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, as amended by Council Directive 2003/123/EC of 22 December 2003, is not reached, more heavily in economic terms than dividends distributed to companies established in its territory, the Federal Republic of Germany has failed to fulfil its obligations under Article 56(1) EC;**

2. **Declares that, by taxing dividends distributed to companies established in Iceland and Norway more heavily in economic terms than dividends distributed to companies established in its territory, the Federal Republic of Germany has failed to fulfil its obligations under Article 40 of the Agreement on the European Economic Area of 2 May 1992;**

3. **Orders the Federal Republic of Germany to pay the costs.**

[Signatures]

* Language of the case: German.