Faculty of Law, Economics and Finance

Tax Base, Tax Rates, and Losses

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EU limits to withholding taxation: Tax base & tax rates

- Combination of **primary & secondary EU law + CJEU case law.**
  - Tax base and rates may be defined/ affected by secondary EU law, DTCs and fundamental freedoms.
  - Focus: CJEU case law: Chronological and thematic approach
  - Different tax bases and different tax rates
    - Tax base: deductibility of expenses (gross vs. net).
    - Consideration of ('foreign') losses.
    - Tax rates: compensation by lower tax rates, progressive vs. flat.
    - Limitations: Secondary EU law, 'funds-specific case law'.

Gerritse: Tax rates and tax base

- **Gerritse (C-234/01)**: Gross v. net tax base: “business expenses in question **are directly linked to the activity** that generated the taxable income in Germany, so that residents and non-residents are placed in a comparable situation in that respect’ .
- “Concerning […] the tax-free allowance, **since […] it has a social purpose**, allowing the taxpayer to be granted an essential minimum exempt from all income tax, **it is legitimate to reserve the grant of that advantage to** persons who have received the greater part of their taxable income in the State of taxation, that is to say, as a general rule, **residents**”.
- “the rate **of 25% [cannot be] higher** than that which would actually be applied to the person concerned, in accordance with the progressive table, in respect of net income increased by an amount corresponding to the tax-free allowance”.
- → Distinction between tax base and tax rate for persons subject to limited taxation.
- ≈ **Scorpio** (C-290/04) → Impossibility to deduct business expenses = incompatible with EU law, for not directly linked expenses, possibility of **refund procedure** after the payment of income tax **+** no reference to the different applicable tax rates (overall tax burden): progressive tax rates for residents up to 53% vs. flat rate WHT 15%.

- Objective comparability depends on the **territorial connecting factor between the activity and the expenses**
  - Centro Equestre (Case C-345/04): " […] expenses which have **a direct economic connection** to the provision of services which gave rise to taxation in that State and which **are therefore inextricably linked to those services**, such as travel and accommodation costs. **In that context, the place and time at which the costs were incurred are immaterial**" (para. 25).
  - Cf to Futura Participations (C-250/95, para. 21): On the other hand, for the purpose of **calculating the basis of assessment for non resident taxpayers**, only profits and losses arising from **their [source] activities are taken into account in calculating the tax payable by them in that State.**
  - Can expenses connected to other States not be taken into account? (territoriality principle, Futura).

Evolution of case law in relation to tax base

- **X NV**, C-498/10 (≈ Scorpio, interposition of payment debtor): When assessing compatibility of the WHT with the freedom to provide services: 'the obligation to withhold tax at source is liable to both render cross-border services less attractive for resident service recipients than services provided by resident service providers […] **irrespective of the effects that the withholding tax may have on the tax situation of non-resident service providers […] [I]t is irrelevant** whether the non-resident service provider **may deduct the tax withheld** in the Netherlands from the tax for which he is liable in the Member State in which he is established'.
- Accepted justification = Effective tax collection
- **Scorpio**: absence of final tax liability and absence of EU administrative cooperation instruments.
- **X NV**: 'serious burden on the foreign service provider in that he would have to submit a tax return in a foreign language and to familiarise himself with a tax system in a Member State other than that in which he is established'
  - (Prevention of tax fraud) Rejected in Comm. v. Belgium (C-433/04) : not proportionate – applied to payments to all contractors even in absence of tax liability (alternatives at paras. 39-40 : exchange of information system or "contractors' tax compliance self-check")

- Miljoen (C-10/14), X(C-14/14) and Société Générale (C-17/14): **direct link of the expenses to the activity** that generated the taxable income in a Member State → in case of dividends, 'such a link exists only if those expenses, which may in some circumstances be directly linked to a sum paid in connection with a securities transaction**, are directly linked to the actual payment of that income' (par. 58)**

  → deduction of the dividend included in the purchase price of the shares and financing charges resulting from ownership of the shares concerned = excluded despite being connected to the dividend but not connected to the actual payment of the dividend.

  → SG argued that not only direct expenses attributable to the dividends should be included but also negative effects of rates and transactions on shareholdings < CJEU: No (no such direct link)

  →Confirmation of Gerritse → need for connection to the activity rather than the proceeds from the activity

- **Brisal (C-18/15):** interest income: 'business expenses directly related to the income received in the Member State in which the activity is pursued must be understood **as expenses occasioned by the activity in question, and therefore necessary for pursuing that activity.** […[W]ith regard to] the granting of a loan, […] the performance of that service necessarily gives rise to business expenses such as, for example, **travel and accommodation expenses, and legal or tax advice**, for which it is relatively easy both to establish the direct link with the loan in question and to prove the actual amount involved.' [paras. 46-47]
- '[…] the pursuit of that activity also **occasions financing costs** which must be regarded **as necessary to the pursuit of that activity**, but in respect of which it may prove more difficult to establish a direct link with a given loan or the actual amount involved. The same is true […] as regards **the fraction of the general expenses of the financial institution** which may be regarded **as necessary** for the granting of a loan.' (p. 48)
- AG Kokott: **only financing costs with a direct link** to the grant of a specific loan count as direct costs, or (also) the share of the whole of the undertaking's financing costs **(overheads)** which may be allocated to it?

→ the mere fact that that evidence is more difficult to provide cannot authorise a MS to refuse deduction as long as the non-resident provides relevant proof.

→ It is for the referring court to decide which business expenses and what fraction of general expenses are directly linked to the activity.

Tax base: Deductibility of expenses

- **Viva Telecom Bulgaria**, C-257/20: WHT on notional (gross amount of) interest on an interest-free loan granted by a non-resident parent to a resident subsidiary (payable under market conditions) →Cash flow disadvantage arising from the option **of refund** upon submitting tax return.
- restrictive measure on free movement of capital but justifiable on grounds of balanced allocation of taxing rights and effective collection of taxes. BUT CJEU reservation on tax base:
  - "if the withholding tax can be levied on the **gross amount of the interest**, without it being possible to deduct, at that stage, expenses related to that loan **since a subsequent application to that effect** is necessary for the purpose of recalculating that tax and making a possible refund**, in so far as, the length of the procedure** laid down for that purpose by that legislation is not excessive and, interest is owed on the amounts refunded."
  - Refund issued within 30 days from request (that can only be made in the next financial year) = acceptable

- **Turpeinen, C-520/04 (9 November 2006)** ≈ Gerritse ≈ Scorpio
- **Tax rates:** Withholding tax on pensions paid to a non-resident (flat 35% rate) vs. for progressive taxation for residents (Turpeinen's case = tax rate of 28.5%).
- Article [18 TFEU] must be interpreted as meaning **that it precludes national legislation** according to which the income tax on a retirement pension paid by an institution of the Member State concerned to a person residing in another Member State **exceeds in certain cases** the tax which would be payable if that person resided in the first Member State, **where that pension constitutes all or nearly all of that person's income** (application of Schumacker doctrine C-279/93: non resident ≈ resident)

- **Compensation by lower tax rate?** Can the disadvantage of no deduction of business expenses be set off by a lower tax that applies to persons subject to limited taxation in comparison with persons subject to unlimited taxation? [AG Kokott Brisal]
  - → Similar issue in Scorpio (but not discussed by the CJEU!)
- Reference to Hirvonen (C-632/13) in combination with Gerritse < acceptance of gross basis if the result is no higher than it would be if net income were taxed at the tax rate applicable to persons subject to unlimited taxation **(→ criterion = ultimate tax burden):** AG Kokott: rejected, inconsistent with case law
- The refusal of deduction of business costs **is (in and of itself)** incompatible with relevant freedom: '[…] **deduction of expenses and the amount of the tax rate are thus always to be assessed separately** for their compatibility with the fundamental freedoms'
  - Consistent with settled case law 'disadvantageous tax treatment which infringes a fundamental freedom cannot be justified by other tax advantages.'
  - Consistent also with equal treatment in case of loss-making entities 'If the amount of the costs directly linked with the activity lead ultimately to a loss, a person subject to limited taxation is disadvantaged regardless of the tax rate.' (confirmed later in Sofina)

- **Sofina and others (C-575/17 22 November 2018)**
- Belgian Cos requesting reimbursement of dividend WHT levied in France for the years these companies were in an **overall loss position.**
  - WHT put BE cos at a disadvantage compared to French resident companies, which were not subject to withholding tax in the same circumstances → Dividends received by resident cos. are included in the normal tax base = subject to the ordinary 33.33% tax rate if the company is in an overall profit position. If a loss is sustained during a financial year, it shall be treated as a charge in the following financial year and shall be deducted from the profit recorded for that year. Any excess loss shall be carried forward to subsequent financial years.
- "It follows 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" → Unjustified restriction to the free movement of capital.

- **Sofina:** The proportionate solution according to the CJEU is extending the benefit also to non-resident loss-making taxpayers alongside a recapturing mechanism in future years of profit. → Source state taking into account foreign losses.

  → Danger of double dip (carry forward also at residence state) mitigated by loss recapture mechanism?

  → Which MS's system to confirm (and compute) the existence of a loss? Source vs. **Residence.**

  → Compatibility with losses' case law? Territoriality?

  - Cf (again!) Futura: "for the purpose of calculating the basis of assessment for non-resident taxpayers, only profits and losses arising from their [source state] activities are taken into account in calculating the tax payable by them in that State".

  →Compatibility with (posterior) Viva Telecom Bulgaria? Recipient of interest was at a loss under rules of residence state (not considered by the CJEU).

Conclusions

- Tax base: Is the distinction between ‘direct’ and ‘indirect’ business expenses (still) relevant?
  - ‘every expense which is necessary in order to carry out the taxed activity is directly linked to that activity. Thus, the concept of ‘direct link’ is not to be interpreted narrowly’. [AG Kokott]
  - ‘any expense recognized for tax purposes is a business expense and thus is somehow connected to the activity of the enterprise.’ (I. Lazarov, 2023)
- Consideration of expenses incurred in another State? Losses? Relationship between (related) expenses and losses?
  - Territoriality (Futura), compatibility with ‘losses-specific’ case law?
- Relevance of passive vs. active income, PIT vs. CIT?
- Separate assessment of tax base and tax rates.
- Role of effective collection of taxes in definition of tax base. When can imposition of WHT on gross income become acceptable? Never (Brisal)? If refund within reasonable time? (Viva Telecom)?

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Thank you!
Questions?

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