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ECJ ruling in Commission v Italy: withholding tax on dividends unlawful?

The Italian dividend taxation system exempts domestic dividends to 95% but charges 27% withholding tax ("WHT") on distributions to foreign shareholders subject to certain exceptions. The Commission contended that Italian law infringed article 56 (1) EC (free movement of capital) as well as articles 31 (freedom of establishment) and article 40 (free movement of capital) EEA in that it treated dividends paid to companies in other EC/ EEA member states less favourably than those paid to domestic companies.

The Court held that the Italian law did breach article 56 (1) EC. Whilst it was correct that a clause in a double tax convention ("DTC") might succeed in ensuring compliance with treaty obligations this was only the case if the DTC allowed for the effects of the difference in treatment to be compensated for. This was only the case if the DTC obliged the foreign country to give a full tax credit for the WHT, which would mean a repayment in cases where the tax charge in the other Member State is lower than the WHT rate in Italy. The Court limited this decision to dividends to the EU because Italy contended that it did not have exchange of information clauses in its DTCs with the other EEA member states.

Conclusion

As far as we know, no DTC provides for a full tax credit. This judgment means that, insofar as WHT is levied by an EC Member State on dividends paid to another Member State whilst preferential treatment is given to domestic dividends, the WHT is unlawful. The same would apply if the recipient was in a country outside the EU provided the DTC included a change of information clause. On this basis it is likely that many WHTs are unlawful.

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