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## **DEVELOPMENT IN RESPECT OF EU LAW MAY MAKE CERTAIN INVESTMENT FUNDS ELIGIBLE FOR TAX REFUND CLAIMS**

The following memorandum looks at the withholding tax charged by a EU Member State on dividends distributed to a tax exempt parent company, which can be an investment fund such as a Luxembourg SICAV, resident in another EU Member State and which may be in breach of EU law. Based on specific conditions as cited below, certain tax refund claims may be made, however, they may be subject to time limitations and should, therefore, be filed with the competent tax authorities of the relevant EU Member State promptly.

### **1. BACKGROUND**

On June 18, 2009, the European Court of Justice (ECJ) delivered its decision C-303/07 in the case between Aberdeen Property Fininvest Alpha Oy and the Finnish tax authorities (the Case). It stated that Article 43 and 48 of the EC Treaty (on the freedom of establishment) must be interpreted so as to preclude legislation of a Member State which:

- exempts from withholding tax dividends distributed by a subsidiary resident in that State to a capital company resident in the same Member State (irrespective of whether or not the parent company qualifies under Article 2 of the EU Parent-Subsidiary Directive (90/435/EEC) of July 23, 1990, as amended or its local implementation rules); but
- charges withholding tax on similar dividends paid by a domestic subsidiary to a parent company in the form of an open-ended investment company (SICAV) resident in another Member State which (i) has a legal form unknown in the law of the former State, (ii) does not appear on the list of companies referred to in Article 2(a) of Parent-Subsidiary Directive and (iii) is exempt from income tax under the law of the other Member State.

### **2. EXECUTIVE SUMMARY**

The Case follows two other important ECJ cases, namely those concerning Denkavit and Amurta.

In the Denkavit (C-170/05) case, the ECJ sets forth that the principle of freedom of establishment provided for in articles 43 EC and 48 EC is to be interpreted to preclude national legislation which, in imposing a tax liability on dividends paid to a non-resident parent company and allowing resident parent companies (almost full) exemption from such tax, constitutes a discriminatory restriction on the freedom of establishment.

In the Amurta (C-379/05) case, the ECJ applied the above principle (in the framework of the free movement of capital provided for in Articles 56 EC and 58 EC) and specified that the discriminatory effects of a national legislation on a taxpayer can be neutralised by benefits in the form of a full tax credit granted to him/her under the legislation of the other Member State is irrelevant to determine whether such legislation is in breach of EC Treaty.

### 3. FACTS

The Case concerns the Finnish company, Aberdeen Property Fininvest Alpha Oy (**Aberdeen**), which is a wholly owned subsidiary of a Luxembourg SICAV, Nordic Fund SICAV (the **SICAV**) an open-ended investment company.

Aberdeen requested an exemption from Finnish withholding tax with respect to its dividend payments to the SICAV, but the Finnish tax authorities declined this request. Under Finnish income tax law, before January 1, 2009 (which is the period relevant to the Case), a dividend received by a Finnish corporation is, in principle, not considered as taxable income<sup>1</sup>, except in certain specific circumstances<sup>2</sup>. In the meantime, however, for dividends paid by a Finnish company to a non-resident entity, a withholding tax is charged. The withholding tax is also applicable to shares in the profits of investment funds<sup>3</sup>. It is not charged on a dividend paid to a corporation resident in a Member State of the European Union which directly owns at least 20% of the share capital of the company paying the dividend, provided that the recipient of the dividend is a company within the meaning of Article 2 of Directive 90/435. Dividends not covered by this exception are subject to withholding tax, the rate of which is determined by the tax treaty between the Member State of residence of the recipient shareholder and the Republic of Finland. In the absence of a tax treaty, a 28% rate applies to the gross amount of the dividend payment.

Aberdeen asked the Finnish Central Tax Commission (Keskusverolautakunta) whether it was obliged to charge withholding tax on dividends paid to the SICAV, with respect to Articles 43 EC and 56 EC and the fact that a dividend paid to a Finnish capital company which would be comparable to a SICAV or to any other corporation similar to a SICAV which is resident in Finland would not be taxable income under Finnish law and would not be subject to withholding tax.

The Finnish Central Tax Commission took the view that Aberdeen was required to charge withholding tax on the dividends paid to the SICAV.

Aberdeen challenged the decision of the Finnish Central Tax Commission before the Finnish Administrative Court (Korkein hallinto-oikeus). The latter decided to stay the proceedings and refer to the ECJ the question of **whether Articles 43 EC and 48 EC (on the freedom of establishment) and 56 EC and 58 EC (on the freedom of movement of capital) preclude legislation of a Member State which exempts from withholding tax or income tax dividends distributed by a subsidiary resident in that State to a capital company or investment fund also resident in that State (irrespective of whether or not the parent company qualifies under Article 2 of the EU Parent-Subsidiary Directive or its local implementation rules), but charges withholding tax on**

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<sup>1</sup> Paragraph 6a of the Laki elinkeinotulon verottamisesta (law on the taxation of business income, 360/1968) of 24 June 1968, which governs the taxation of dividends received by share companies established in Finland, in the version of 30 July 2004.

<sup>2</sup> 75% of a dividend is taxable income and 25% tax-free income if:

(1) the dividend is received on shares forming part of investment property and the corporation distributing the dividend is not a foreign corporation within the meaning of Article 2 of the Parent-Subsidiary Directive of whose share capital the recipient of the dividend owns directly at least 10% when the dividend is distributed,

(2) the corporation distributing the dividend is not a Finnish corporation or a corporation resident in an EU Member State within the meaning of indent (1), or

(3) the corporation distributing the dividend is a publicly quoted company within the meaning of the second subparagraph of Paragraph 33a of the Tuloverolaki and the recipient of the dividend is a corporation other than a publicly quoted company which when the dividend is distributed does not own directly at least 10% of the share capital of the company distributing the dividend.

Where there is no agreement for the avoidance of double taxation in force during the tax year between the State of residence of the foreign corporation distributing the dividend within the meaning of indent (2) of the first subparagraph and the Republic of Finland, applicable to the dividend distributed by the corporation, the dividend distributed by the corporation is taxable income in its entirety.

<sup>3</sup> Paragraph 3 of the Laki rajoitetusti verovelvollisen tulon verottamisesta (Law on the taxation of the income of persons with limited tax liability, 627/1978) of 11 August 1978.

**similar dividends paid to a parent company in the form of a SICAV resident in another Member State which has a legal form unknown in the law of the former State, does not appear on the list of companies referred to in Article 2(a) of Directive 90/435 and is exempt from income tax under the law of the other Member State.**

#### **4. DECISION**

The ECJ noted that the above-mentioned Finnish rules on the tax treatment of dividend distributions may - in theory - be within the scope of both principles of the freedom of establishment and the freedom of movement of capital. However, as Aberdeen is a 100% subsidiary of the SICAV which can, therefore, exercise a definite and decisive influence over Aberdeen's decisions, the ECJ decided that this Case relates exclusively to the freedom of establishment.

In the Case, the ECJ sets forth that a capital company or investment fund governed by Finnish law and resident in Finland, whether or not qualifying under Art. 2 of Directive 90/435, is in principle, exempt from tax with respect to dividends received from another company also having its seat in Finland whereas a withholding tax is imposed when the dividends are distributed by a Finnish resident company to a non-resident company which does not qualify under Article 2 of Directive 90/435, can be considered as a restriction of the freedom of establishment prohibited in principle by Articles 43 EC and 48 EC.

The Case includes an application of the principle laid down in the *Denkavit* and *Amurta* cases according to which: once a Member State, unilaterally or by way of 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.

The Finnish (and Italian) Governments argued that a SICAV, unlike a Finnish capital company, is not subject to income tax in Luxembourg. The SICAV is subject only to a tax on capital at the rate of 0.01% (i.e. *the taxe d'abonnement*) and the profits it distributes to a person resident in another Member State are not subject to any withholding tax, whereas dividends received by Finnish capital companies are exempt from tax solely in order to avoid their being subject to a series of charges to tax when profits are distributed between capital companies, while their other income is taxed. The ECJ replied that the circumstance relied on by the Finnish Government, namely that the income of a SICAV is not taxed in Luxembourg, assuming that to be correct, does not create a difference between a SICAV and a resident capital company which justifies a different treatment as regards withholding tax on dividends received by either company.

Furthermore, according to the Italian Government, a real property SICAV, which is not covered by Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) and whose sole purpose is the collective investment of funds raised through the sale of securities to the public constitutes a fundamentally transparent entity which aims, through collective management, to add value to each member's individual contribution and is not comparable in itself to an ordinary company. The specific nature of such a company justifies it being exempt from income tax in the State of residence, since the only income to be taken into account is in reality that of each member. The problem of successive charges to tax does not, therefore, arise at the level of the SICAV but at that of the members, which is for the law of the Member State concerned to remedy. As regards the comparison between a SICAV governed by Luxembourg law and an investment fund governed by Finnish law, the Finnish Government further observed:

- firstly, that during the period at issue in the main proceeding, national legislation prohibited such a tax-exempt fund from making real property investments such as those mentioned in the order for reference.
- secondly, the profits distributed by a SICAV do not give rise to withholding tax in Luxembourg, unlike profits distributed by a Finnish investment fund to a person resident in another Member State, unless a provision in a double taxation convention provides otherwise.

The ECJ replied that there is no merit in the Italian Government's argument because the Grand Duchy of Luxembourg does not tax the income of a SICAV. The imposition of a series of charges to tax takes place not at the level of the SICAV but at that of its members and should be avoided by the Member State in which those members reside. It is the Republic of Finland which, by subjecting to withholding tax income that has already been taxed at the level of the distributing company, creates the series of charges to tax - a series which that Member State chose to prevent in the Case of dividends distributed to resident companies.

In those circumstances, the differences between a SICAV governed by Luxembourg law and a capital company governed by Finnish law, relied on by the Finnish and Italian Governments, are not sufficient to create an objective distinction with respect to exemption from withholding tax on dividends received. Consequently, there is no further need to examine the extent to which the differences between a SICAV governed by Luxembourg law and an investment fund governed by Finnish law put forward are relevant for establishing such an objective difference in situation.

Additionally, the justifications put forward by the Finnish and Italian Governments (prevention of tax avoidance, prevention of abusive practices, balanced apportionment of the power to tax preservation of the coherence of the Finnish tax system) have not been accepted by the ECJ which concluded that **the difference in treatment between non-resident SICAVs and Finnish resident capital companies with respect to the exemption from withholding tax on dividends distributed to them by Finnish resident companies constitutes a prohibited restriction of the freedom of establishment.**

## 5. CONSEQUENCES

This represents the first time that the ECJ has considered the compatibility with the EC Treaty of a withholding tax applied to dividend distributions to non-resident recipient investment funds. The preceding Denkavit and Amurta cases concerned "ordinary" recipient companies.

The Case is very clear and should eliminate many further objections from the European Commission or local government to refund withholding tax levied in breach of the EC Treaty (past or future) subject to national laws and procedures. In this respect, it is also to note that the EU commission has initiated infringement procedures against other EU Member States because of the probable incompatibility of their domestic rules with EU principles. These procedures concern alleged discriminatory taxation of either outbound dividends in general, or outbound dividends as well as interest payments to EU pension funds specifically.

## 6. NEXT STEPS

Consequently, we recommend that all investment funds, regardless of their legal structure, UCITS or non-UCITS, now review their past and future withholding tax position and consider the cost/benefit of making withholding tax reclaims.

Such reclaims should be possible if the legislation under which a tax has been withheld on dividend distributions made by an entity located in an EU Member State to an investment (or pension) fund

located in another EU Member State does not provide for a similar taxation for outbound dividend distributed to an investment fund located in the same EU Member State as the distributing company.

The Netherlands has already begun to pay out claims and other countries are expected to follow suit soon. However, investment funds that have yet to file claims for the recovery of taxes should be aware that a statute of limitation will apply in each Member State to restrict the level of payouts, thereby increasing the need for prompt action.



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