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**Refund of Withholding Tax to non-EU funds is possible, but proof of comparability is required**

[http://www.bepartners.pro/documents/2014-04-10\\_ECJ\\_C-190-12.pdf](http://www.bepartners.pro/documents/2014-04-10_ECJ_C-190-12.pdf)

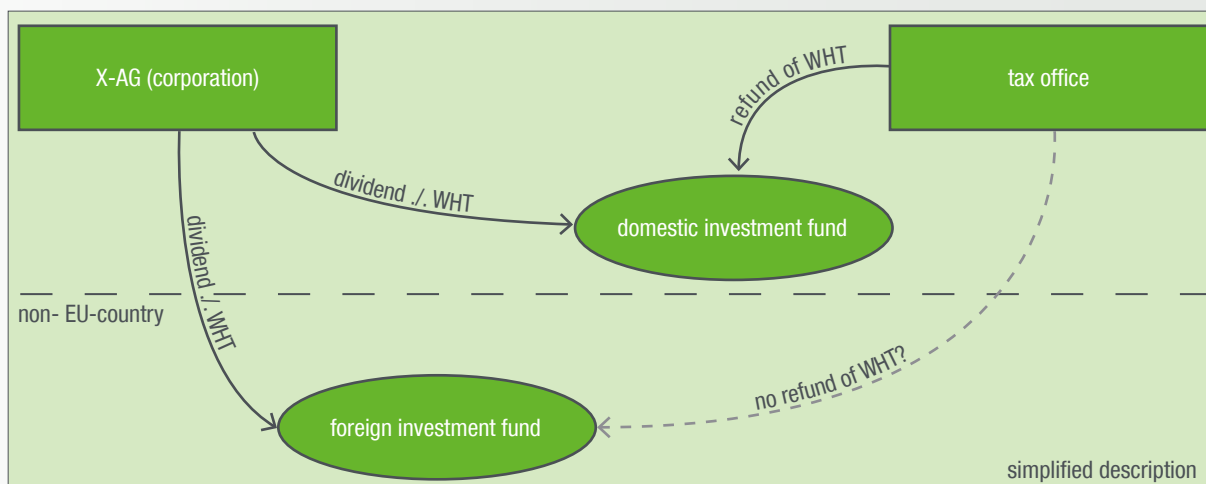
The European Court of Justice (ECJ) published a decision on 10 April 2014 ruling that withholding tax on dividend distributions to funds located in non-EU countries may constitute a breach of the principle of free movement of capital if dividend distributions to comparable domestic investment funds are tax-exempt. Comparability does not demand an application of comparable regulations in the state of residence but the proof of a factual comparability with a domestic fund. In addition, the involved states must be bound by an obligation under a convention on mutual administrative assistance and exchange of information and thereby be in a position to verify any information that may be transmitted by the fund to prove the comparability (ECJ, decision dated 10 April 2014, “Emerging Markets Series of DFA Investment Trust Company” - C-190/12).

The recent decision of the ECJ can be applied to the German legal situation in so far as only investment funds resident in Germany can obtain a refund of withholding tax according to the German Investment Tax Act (Investmentsteuergesetz). According to the ECJ decision, a foreign investment fund will be obliged to prove the comparability to German funds by

fulfilling similar requirements as laid down in the past in the German Investment Act (Investmentgesetz) and now in the German Investment Tax Act.

**1. Facts of the case**

The decision is based on a request for a preliminary ruling brought to the ECJ by a Polish court that had to decide on a case brought by an investment fund established in the United States. The fund received dividends from a corporation resident in Poland on which 15 % withholding tax was levied. The fund applied for a refund of withholding tax (WHT) to the Polish fiscal authorities but its request was rejected. According to the regulations in Polish Corporation Tax Act only dividends received by investment funds established in Poland were exempted from tax, if the fund met the conditions of the Polish Investment Act (which was especially true for UCITS). In contrast, dividends paid to investment funds established outside of Poland were not covered by the tax exemption. The investment fund based its suit on a breach of the Polish regulation of the principle of free movement of capital arguing that it constitutes a violation of the fundamental freedoms to levy tax on dividends paid to investment funds located outside of Poland, whereas domestic investment funds are ex-





empt from tax. The Polish court referred to the ECJ with two questions for a preliminary ruling. First, it asked whether the prohibition of restrictions on free movement of capital applies in the context of a national law which draws a distinction regarding the taxation of a domestic investment fund and an investment fund, which is a tax resident of the United States. Further, the Polish court applied for a decision concerning the question whether the different treatment between domestic and foreign investment funds can be legally justified notably by the need for effective fiscal supervision.

## **2. The ECJ ruling**

### **2.1. Restriction on the free movement of capital**

The Court found that the affected regulation constituted a restriction on the free movement of capital (Art. 63 TFEU). This freedom is one of the fundamental freedoms on which the internal EU market is based. It applies not only to transactions between EU Member States but in general also to transactions between an EU Member State and a non-EU state such as the USA. There exists a series of decisions of the ECJ, partially involving investment funds, to dismiss rules discriminating foreign investors compared to similar domestic investors with respect to the taxation of dividends. The Court found in the actual case that, on the one hand, the rule may discourage investment funds established in a non-EU state from investing in companies established in Poland and, on the other hand, it may discourage Polish investors from acquiring shares of non-resident investment funds, so that a restriction was given.

### **2.2. Justification in the name of the need to guarantee effective fiscal supervision**

Concerning the question whether this restriction can be justified in order to guarantee the effectiveness of fiscal supervision, the Court came to a different result as the Advocate General (AG) did in his final opinion.

In earlier decisions, the Court already refused to apply this justification in cases where only EU Member States were affected. In those cases, the Court found that the absolute refusal by a Member State to grant a tax benefit to a non-resident taxpayer by prohibiting him from submitting evidence that he can satisfy the conditions required to obtain that benefit, can regularly not be justified in the name of the need to guarantee the effectiveness of fiscal supervision. Based on that jurisdiction, the AG argued that in his opinion the refusal of the tax exemption in the recent case was lawful, as there was no obligation to an exchange of information with the competent authorities in the USA, similar to that agreed upon between the EU Member States.

The ECJ did not follow this argumentation completely. It

came to the result that the absence of a similar regulatory framework concerning the exchange of information as exists between EU Member States may not justify a regulation that does not give taxpayers the opportunity to prove that they satisfy requirements which are equivalent to those contained in the national law on investment funds. It rather has to be analyzed if there is a framework of mutual assistance and exchange of information that enables the source state to ascertain whether equivalent requirements as put up by the national law are met by the foreign investment fund in order to grant the tax exemption. The Court referred to the clause concerning the exchange of information in the Double Tax Convention between Poland and the USA as well as an agreement between the Council of Europe and the OECD on mutual administrative assistance in tax matters that might form the framework in order to receive the relevant information needed to ascertain the documentation provided by the investment fund in order to prove the comparability to domestic investment funds. The Court held that it was up to the referring court to decide whether those provisions were in fact capable of enabling the Polish tax authorities to verify the documentation provided by the funds.

### **3. Decision means an evolution of the jurisdiction on discriminating dividend taxation**

The actual decision can be seen as a further development of the ECJ's jurisdiction concerning the different tax treatment of domestic and foreign investment funds. Whereas the Court left the question, whether a taxation of non-EU investment funds can be justified, explicitly open in the "Santander" case regarding the French legal situation likely comparable to the one in the recent case, the Court now states that even in cases concerning non-EU states a taxation of dividend payments without exception cannot be justified. A restriction may not be justified if relevant measures of mutual administrative assistance and exchange of information exist that enable the verification of every information provided by the investment fund in order to prove the comparability of the foreign investment vehicles to domestic investment vehicles.

### **4. Ruling can be applied to German law**

The decision can be applied to German Law in its basics. According to German Law, domestic investment funds are exempt from tax and may accordingly apply for a refund of withholding tax. For EU and non-EU investment funds, there is no possibility to profit from a (complete) WHT refund.

Since 2014, when the German Investment Law and the German Investment Tax Law were amended in order to transpose the AIFMD into national law, the tax exemption is only granted to investment vehicles qualifying as "investment funds" in a



technical sense, i.e. UCITS or AIF that fulfill the demands of the term as defined in the German Investment Tax Act (e.g. supervision, right to redeem shares annually, risk diversification, investments only in permitted asset classes). Regarding those requirements, the foreign fund may, according to the recent decision, prove its comparability. If it does not meet the requirements set up for "investment funds" in the described technical meaning, it will not qualify for a tax refund as domestic investment vehicles that do not meet those requirements will not profit from the tax exemption either. If the fund meets the requirements, it will be able to apply for a refund if – this is an additional criterion – there exist measures of mutual administrative assistance and exchange of information that enable the German fiscal authorities to verify any information transmitted by the investment fund to prove the comparability to domestic vehicles. In the ECJ case, such measures were to be found in the information exchange clause contained in the Double Tax Convention, which was generally based on the clause provided by the OECD model convention. Re-

garding the period before 2014, the proof of comparability will only concern the evidence that the fund invests in assets according to the abolished German Investment Act.

#### **5. Application for refund of WHT for non-EU funds remains possible, but evidence of comparability based on measures of exchange of information is needed**

The recent decision means a positive signal for investment funds established outside the European Union. In contrast to the final opinion of the Advocate General, the door for applications for refund of WHT remains open. However, the requirement to prove comparability with domestic funds and the required measures of mutual administrative assistance and exchange of information in order to verify the information provided by the fund impose high hurdles to be met for successful requests. The exact requirements regarding the comparability will have to be determined by the national courts.

**be in touch: If you have any questions, please do not hesitate to contact us!**



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