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Article 63 and withholding tax on foreign funds: Another step on the road to refund

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Köln-Aktienfonds Deka (Case C-156/17, 30 January 2020)

Background

Köln-Aktienfonds Deka (“**KA Deka**”) is an investment fund constituted under German law. It is a UCITS within the meaning of Directives 85/611 and 2009/65, open-ended, listed on the stock exchange, without legal personality and exempt from tax on profits in Germany. It makes investments on behalf of individuals.

During the financial years 2002/2003 to 2007/2008, KA Deka received dividends distributed by Dutch companies, in which it held shares. Those dividends were subject, in accordance with the Netherlands-Germany double tax treaty (“**DTT**”), to a tax of 15%, which was withheld at source. KA Deka, unlike an investment fund established in the Netherlands meeting the conditions enabling it to qualify as a fiscal investment enterprise (“**FIE**”), was not able to benefit from the repayment of that tax based on Article 10(2) of the Law on the Taxation of Dividends of 1965.

FIEs are subject to a zero-corporation tax rate and benefit from the refund of dividend tax withheld on dividends received in the Netherlands. In order for an undertaking to qualify for the FIE regime, one of the conditions that needs to be fulfilled is that it distributes its income to its shareholders or participants within 8 months following the financial year end. When they distribute dividends, FIEs are required to withhold Netherlands tax on the recipient’s dividends. KA Deka is not subject, in the Netherlands, to the obligation to withhold tax on dividends that it has itself distributed. Furthermore, it is required that the participants in the investment undertakings are predominantly individuals without a significant concentration of shares in the hands of single investors.

FIEs are also entitled to a reduction of dividend withholding tax on profit distributions in respect to tax deducted at source on their investment products abroad.

The FIEs regime is intended to enable natural persons, and, in particular, small investors, to make collective investments in certain types of assets. The aim of that regime is to bring the tax treatment applicable to private individuals who invest through an FIE in line with the tax treatment of private individuals who make investments on an individual basis.

KA Deka applied for a refund of the dividend tax deducted from its dividends distributed by Netherlands companies for the financial years 2002/2003 to 2007/2008 to the Netherlands tax authorities, which was rejected. When bringing an action before the District Court of Zeeland-West-Brabant (Netherlands), KA Deka argued that its situation could be compared to that of an investment fund established in the Netherlands which has the status of an FIE, as referred to in Article 28 of the Law on Corporation Tax of 1969, and that it was therefore entitled to a refund of the dividend tax under Article 63 TFEU.

The Supreme Court of the Netherlands noted, as a preliminary point, that, in its legal form, KA Deka could be classified as an FIE and is, in that regard, objectively comparable to an FIE established in the Netherlands. The Supreme Court states that, whereas an FIE established in the Netherlands would have been entitled to the refund of WHT, KA Deka cannot derive any right to a refund of dividend tax either from Netherlands legislation or from the DTC between the Netherlands and Germany.

The questions referred to the CJEU were as follows:

(1) Does art.63 TFEU mean that an investment fund established outside the Netherlands cannot be refused, <u>on the ground that it is not subject to an obligation to withhold Netherlands dividend tax</u>, a refund of Netherlands dividend tax which was withheld on dividends which that investment fund received from corporate bodies established in the Netherlands, when such a refund is granted to a fiscal investment enterprise established in the Netherlands, which, subject to the withholding of Netherlands dividend tax, distributes the proceeds of its investments to its shareholders or participants on an annual basis?

(2) Does art.63 TFEU mean that an investment fund established outside the Netherlands cannot be refused a refund of Netherlands dividend tax which was withheld on dividends which it received from corporate bodies established in the Netherlands on the sole ground that it has not proved in a satisfactorily manner that its shareholders or participants satisfy the conditions laid down in Netherlands legislation?

(3) Does art.63 mean that an investment fund established outside the Netherlands cannot be refused a refund of Netherlands dividend tax which was withheld on dividends which it received from corporate bodies established in the Netherlands, on the ground that it does not distribute the proceeds of its investments in full to its shareholders or participants on an annual basis at the latest in the eighth month following the end of the financial year, even if, in the country in which that investment fund is established, under the legislation there applicable, the proceeds of its investments, to the extent to which they are not distributed, (a) are deemed to have been distributed, and/or (b) are taken into account in the tax levied in that country on the shareholders or participants as though those profits had been distributed, whereas such a refund is granted to a fiscal investment enterprise established in the Netherlands, which, subject to the withholding of Netherlands dividend tax, distributes the proceeds of its investments in full to its shareholders or participants on an annual basis?'

Analysis of the CJEU

<u>The first question referred was withdrawn</u> by the Dutch Supreme Court following the delivery of the judgment of 21 June 2018, Fidelity Funds and Others (C-480/16, EU:C:2018:480). In the latter case, the Danish Ministry tried to argue that due to the need to safeguard the coherence of the tax system and ensure a balanced allocation of power to tax between Member States, such discrimination would be justified. This would have been one of the few justifications for a discriminatory tax treatment.

The Danish Ministry further argued that the difference in tax treatment was justified by the direct link between the exemption from withholding tax on dividends paid to resident UCITS and the need to deduct Danish withholding tax on distributions paid out by the UCITS to its investors.

The CJEU refuted the above argument on the grounds that levying withholding tax on distributions from Danish companies to non-resident UCITS and these UCITS levying withholding tax on the distributions made to their investors actually creates a series of charges to tax on the dividends paid ultimately to the UCITS investor, which is contrary to the objective of the Danish tax law (the objective being to avoid cascading layers of tax).

With regards to the second question, the CJEU underlined that measures discouraging non-residents from making investments in a Member States, or residents to invest in another Member State, are restrictions on the free movement of capital (confirming a consistent case law, such as C-190/12, *Emerging Market Series of DGA Investment Trust Company*, 2014, and C-575/17, *Sofina and Others*, 2018). In the case at hand, the requirements to obtain the FIE status depended on whether the fund's shares or certificates of participation were listed on a regulated market. Furthermore, a restriction with regards to the quality of the investors exists (predominantly individual investors with minor participation).

Although the Dutch legislation at hand applies without distinction between resident and non-resident investment funds, this legislation can nonetheless constitute a restriction of the free movement of capital. This could be specifically the case when obligations or conditions specific to the national market were applied to non-residents.

In the case at hand, investment funds not listed on the Amsterdam Stock Exchange had to meet conditions which were stricter than those for investment funds which were. The CJEU left it to the Supreme Court to determine whether this could constitute a *de facto* disadvantage to non-residents. The CJEU also left to the Supreme Court the question whether resident funds were in fact required by the Dutch tax administration to provide the proof that was requested of foreign funds. It should be noted that each Member State tax authority may require such level of proof as they may consider it necessary in order to take a position. However, non-resident investment funds should not be subject to an excessive administrative burden. In the case at hand, KA Deka was not able to provide enough proof due to the share trading system chosen and this was not a result of any restriction implied by European or local legislation. Therefore, the CJEU concluded that the level of proof required in order to evidence the quality of the investors does not constitute a restriction of the free movement of capital.

With regards to the third question, the issue related to the fact that one of the conditions for the refund was that the fund had to distribute the proceeds of the investments in full to the shareholders on an annual basis within 8 months of the financial year. In Germany, the legal provisions applicable towards KA Deka states that the proceeds of the investments which have not been distributed are deemed to have been distributed and considered in the tax levied on the shareholders and participants of KA Deka.

The CJEU considered that it cannot be excluded that a non-resident investment fund does not meet all the conditions laid down by another Member State conferring a tax advantage, due to the regulatory framework in its State of establishment. However, the fund may still be in a situation essentially comparable to that of a resident investment fund meeting those conditions. The conditions must therefore not create a *de facto* discrimination against investments funds in a comparable situation.

With regards to the objective of the distribution requirements to ensure effective taxation of the dividends in the hands of the investors in the funds, the refusal of WHT refund based on non-compliance with this requirement, would, in the present case, constitute a restriction of the free movement of capital, given that the German tax system provides for a comparable taxation mechanism (i.e. taxation on undistributed income). Having made this determination, strangely, the CJEU left it to the Supreme Court to determine whether the German and Dutch fund were comparable, having regard to the objective underlying the Dutch conditions.

Conclusion

This present ruling is one in a series of rulings and should shed light on the refund claims made by numerous investment funds in EU jurisdictions. For the Dutch practice, this ruling is specifically interesting and may be considered as yet another step towards a clear precedent.

The case is particularly interesting for foreign funds that have a taxation system that is comparable but not identical to the Dutch system. The Dutch system required annual distribution of all income to ensure taxation in the hands of investors. US RICs, for example, are also required to distribute their income annually with the US tax system having the same objective as the Dutch system.

Following the decision, the Dutch Supreme Court invited us to provide them with our point of view on the case. More specifically the Dutch Supreme Court provided us with the opportunity to point out how the KA Deka case should/could affect the answers on the prejudicial questions raised in the leading US RIC case. Part of the questions raised by the Supreme Court at the time were related to Dutch investment funds eligible for WHT refund and the Dutch WHT liability. We remain of the opinion that the discrimination towards foreign funds is evident and therefore they should be eligible for a WHT refund.

In any case, in our view, the decision provides much needed clarity on a number of issues. In particular, when assessing whether a non-resident fund is in an objectively comparable position to a resident fund, the main objective of the underlying legislative measure should be considered.

Do you have further questions?

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