DE BRAUW
BLACKSTONE
WESTBROEK

New ECJ ruling likely to impact Dutch dividend tax treatment of foreign investment funds

July 12, 2018

On 21 June 2018, the European Court of Justice ruled that the Danish withholding tax on dividends distributed to non-resident undertakings for collective investment in transferable securities (UCITS) is incompatible with free movement of capital.

In this case, two foreign UCITS held portfolio investments in Denmark. Under Danish law, distributions made to non-resident UCITS are subject to withholding taxes, while distributions made to resident UCITS are exempt. This exemption is subject to certain minimum distribution requirements to safeguard taxation at the investor level. In its recent ruling, the ECJ held that this difference in treatment is incompatible with the freedom of movement of capital.

The ECJ ruling is important for non-Dutch resident UCITS, both inside and outside the EU, that have been subject to Dutch dividend withholding tax on distributions received from Dutch portfolio investments and that have timely filed, or can still timely file, refund requests and appeals.

Background

The ECJ case concerned two Fidelity Funds that held portfolio investments in Danish companies. The Fidelity Funds, both UCITS with registered offices in the UK and Luxembourg, claimed repayment of Danish dividend withholding taxes. Under Danish domestic law, distributions made by Danish companies to a Danish UCITS are exempt from withholding taxes if the UCITS qualifies as an Article 16 C fund, which means that it makes annual notional minimum distributions and withholds the tax payable by its members on that distribution. Non-resident UCITS cannot benefit from such an exemption because they cannot satisfy the residence requirement even if, in theory, they meet the minimum distribution requirement. The two non-resident Fidelity Funds argued that this distinction between resident and non-resident UCITS is incompatible with the EU's free movement of capital.

The Danish legislation restricts free movement of capital

According to the ECJ, Danish legislation restricts the free movement of capital since dividends paid to non-resident UCITS are treated unfavourably compared to dividends paid to resident UCITS. This restriction can, however, be compatible with the free movement of capital if the difference in treatment concerns situations that are not objectively comparable or the restriction is justified by an overriding reason in the public interest. The applicability of these exceptions is the central question in this case, and in similar pending cases. In this case, the ECJ ruled that none of the exceptions apply.

Resident and non-resident UCITS are in comparable situations

In its judgment, the ECJ made clear that comparability must be examined on the basis of the objectives of the domestic tax rules at issue. The objectives of the Danish tax rules in the present case are twofold.

First, they seek to prevent double taxation of investments in Danish companies by private individuals and, therefore, create a tax-neutral treatment compared to private individuals investing directly in Danish companies. The ECJ ruled that this objective in itself does not necessarily result in resident UCITS and non-resident UCITS being in objectively comparable situations. However, the ECJ concluded that non-resident UCITS are comparable with resident UCITS, simply because dividends received from Danish companies by non-resident UCITS are subject to tax in Denmark.

As a second objective, the legislation seeks to ensure that dividends distributed by Danish companies are actually taxed at least once without deferral, either by means of a withholding tax at the level of the distributing company or at the level of the member in the UCITS. This is given effect by the condition that a UCITS must deduct withholding tax, chargeable to its members, from a notional minimum distribution. Although the ECJ mentioned that Denmark may not be able to subject a non-resident UCITS to an obligation to deduct and remit Danish tax, the ECJ ruled that this does not result in an objective difference between resident and non-resident UCITS.

It appears that in the ECJ's view, differences in taxation between investors in resident UCITS and non-resident UCITS are caused by different conditions for taxing those investors and does not affect the comparability of resident and non-resident UCITS. In this respect, the ECJ seems to attach importance to the possibility that a non-resident UCITS could also have Danish investors from whom Denmark could actually levy tax.

The Danish legislation cannot be justified by overriding reasons of public interest

The ECJ then considered whether the restriction on free movement of capital was justified by an overriding reason of public interest that is appropriate and does not go beyond what is necessary. In that respect, the balanced allocation of powers to taxation and the need to safeguard the coherence of the Danish tax system were put forward. While the need to preserve the balanced allocation of taxation powers was rejected, the ECJ held that the restriction could, in principle, be justified by the need to preserve the coherence of the Danish tax system. However, the Danish measures to achieve this were found to be disproportionate.

The ECJ agreed that the restriction was justified by the need to preserve the coherence of the Danish tax system because a direct link exists between the tax advantage concerned – the exemption – and compensating that advantage by applying another tax levy – the withholding tax retained by resident UCITS on actual or notional minimum distributions. However, the method by which the coherence is safeguarded was found to be disproportionate because there are less restrictive measures available that can lead to the same result. The internal coherence would also have been

maintained if non-resident UCITS had been allowed to use the withholding tax exemption, provided that the Danish tax authorities ensure that they pay a tax equivalent to the tax that Danish resident UCITS would have been required to retain as a withholding tax on the notional minimum distribution. This less restrictive measure put forward by the ECJ seems at odds with the conclusion reached by Dutch AG Wattel on 9 November 2016. According to Wattel, the applicable tax treaty in that case prohibits imposing a withholding tax on distributions made by non-resident UCITS.

Regarding the second reason of public interest, the ECJ confirmed that the restriction would, in principle, be justified if the Danish system were designed to prevent conduct which could jeopardise the right of a Member State to exercise its powers of taxation in relation to activities carried out in its territory. The ECJ concluded that Denmark cannot rely on this public interest reason, because the Danish system imposes a tax on nationally-sourced dividends to non-resident UCITS, while exempting such dividends paid to residents. As such, the system seems to compensate for the lack of taxing powers after distribution, rather than being based on the need to ensure the balanced allocation of taxing rights between the member states.

Consequences for other UCITS

The ECJ's judgment makes it more likely that the Dutch dividend withholding tax treatment of non-Dutch UCITS and other comparable investment funds will be considered incompatible with the freedom of capital. Non-Dutch resident UCITS, both inside and outside the EU, that have been subject to Dutch dividend withholding tax on distributions received from Dutch portfolio investments may be able to claim a repayment of Dutch dividend withholding taxes, provided they have timely filed, or can still timely file, refund requests and appeals.

In its coalition agreement, the Dutch government agreed to abolish Dutch dividend withholding tax as of 2020. The abolition would “solve” the issue for distributions from that date.