Global FS Tax Newsflash

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Seminal European Court ruling on the illegality of some European withholding taxes

Background and Information

For some years now European FS institutions, mainly led by the funds industry, have been taking action against certain EU Member States on the basis that in some cases the imposition of withholding taxes on dividends was illegal under the EU Treaty. This was on the basis that EU Member States under the Treaty may not treat foreign investors, and in particular EU and EFTA shareholders, more harshly than equivalent domestic investors. These cases were being pursued under the "Free Movement of Capital" provisions and unusually these provisions in the EU Treaty also granted rights against discrimination to investors in countries that were outside the EU and EFTA. A recent case which concerns France and both EU and non EU investors has been decided in favour of the investors and against France. There are implications potentially for any foreign investor in EU equity investments and therefore will be of wide interest.

Investment funds win case against discriminatory French WHT

Background

The case concerned the French tax rules applicable to dividends distributed by French companies to foreign investment funds. Under the current French tax rules, dividends paid to investment funds which are not resident in France are taxed at source at the rate of 30% (25% prior to 1 January 2012), whereas such dividends are exempt from tax when paid to French-resident investment funds.

Ten investment funds resident in Belgium, Germany, Spain and the United States which invested inter alia in shares in French companies and received dividends from those shares subject to French dividend withholding tax, contested the French tax rules through the French domestic court system on the basis that they breach of the free movement of capital guaranteed by EU law.

The Tribunal administratif de Montreuil (the Tribunal), before which these actions were brought, asked the European Court of Justice (the Court) in essence whether French legislation which taxes French dividends distributed to investment funds differently according to the place of residence of the recipient investment fund violates EU law. The Tribunal also asked whether, for the purpose of determining whether there may be a difference in treatment amounting to discrimination, only the situations of the investment funds must be compared or whether the situation of the shareholders in the investment funds must also be taken into account.

The Court's deliberations

The Court decided that a difference in the tax treatment of dividends according to the investment funds' place of residence may discourage, on the one hand, non-resident investment funds from investing in companies established in France and, on the other, investors resident in France from acquiring shares in non-resident investment funds. Accordingly, the Court concluded that the French legislation constitutes a restriction on the free movement of capital, which is, in principle, prohibited under EU law.

The Court examined whether this restriction (i.e. discrimination) could be potentially justified either on the basis that the French investment funds and non-French investment funds are not in objectively comparable situations or on the basis that there is an overriding reason in the public interest.

Are French and non-French investment funds in comparable situations?

For the purpose of determining whether the situations of the foreign and French investment funds investing into the same French companies are comparable, the Tribunal asked the Court whether the situation of their shareholders must be taken into account along with that of the investment funds. In reply, the Court ruled that the French rules establishes a relevant distinguishing criterion based on the investment funds' place of residence, in that it only subjects the non-resident investment funds to withholding tax on dividends which they receive. In the light of this, the Court considered that for the purpose of determining whether the rules are discriminatory, the situations must be compared only by reference to the investment funds, without taking account of the situation of their shareholders. Accordingly, the different treatment of resident investment funds and non-resident investment funds cannot be justified by a relevant difference in their situations.

Can the French rules be justified by the overriding reasons in the public interest?

The Court also considered whether the different treatment could be justified by overriding reasons in the public interest, as this is acceptable under the terms of the Treaty on the Functioning of the European Union (TFEU). The Court examined a number of arguments put forward by the French Government and summarily and conclusively dismissed each of them. Specifically, the Court said:

- France has chosen not to tax its resident investment funds on receipt of French dividends and therefore it cannot rely on the argument that there is a need to ensure a balanced allocation between the Member States of the EU of the power to tax

- Similarly, the French rules cannot be justified by the need to guarantee the effectiveness of fiscal supervision, since the withholding tax affects solely and specifically non-French residents.

- Lastly, the French rules cannot be justified by the need to preserve the coherence of the French tax system because there is no link between the exemption from withholding tax on French dividends received by a French investment fund and the taxation of those same dividends as income received by the shareholders in that same French fund.

Additional deliberations on the position of non-EU investment funds

The Court also considered whether the different treatment of non-EU investment funds could also be justified by overriding reasons in the public interest. The Court noted that the French Government simply argued that the discrimination should be justified by the need to guarantee the effectiveness of fiscal supervision but then failed to put forward any further evidence to substantiate its point in relation to the position of non-EU investment funds.

Article 64 of the TFEU contains a provision which permits EU Member States to discriminate against non-EU countries in cases of "direct investment" where the relevant law existed on 31 December 1993. The Court noted that the Tribunal did not ask the Court to consider whether French withholding tax rules could be justified under this provision and therefore it did not further comment. However, it is worth noting that the reason why the Tribunal did not ask the Court to consider this justification is that the French Supreme Administrative Court had already ruled on 23 May 2011 that it is only in exceptional situations where the investment made by open-ended investment funds can be qualified as "direct investments" such that the discriminatory effect of the French tax rules could possibly be justified.

Consequently, the Court concluded that it could not find a reasonable justification for the discrimination against foreign investment funds and therefore decided that the French rules which tax at source French dividends when received by foreign investment funds but exempts the same dividends from tax when received by French investment funds as being in violation of EU law and without justification. In its ruling, the Court does not distinguish between foreign EU investment funds and foreign non-EU investment funds.

What next?

Based on the decision of the Court and the 2011 opinion issued by France's Supreme Administrative Court, we expect the Tribunal to confirm the decision of the Court by the end of 2012 in relation to the ten test cases and the further 2,500 cases stood behind them. We understand that the French Tax Administration has received approximately 10,000 fund reclaims since PwC filed the first claims with them in 2004 and estimate that France may end

up refunding up to €20bn of previously withheld taxes back to foreign investment funds.

Our expectation is that the French Tax Administration will issue some guidance commenting on this case, and specifying the conditions on French source dividends declared to non-French investment funds may benefit from a withholding tax exemption and therefore refund. Ultimately, we believe that the French government is likely to eliminate the discrimination by amending the withholding tax rules to apply them to French resident investment funds.

What do these developments mean for investment funds?

The Court ruling on the position of both EU and non-EU investment funds investing into European companies will be welcome news for investment funds that have been subjected to discriminatory withholding taxes on dividends from EU Member States.

The Court also rejected France's request to limit the temporal effects of its decision to claims filed with the French tax authorities before 10 May 2012. Investment funds should contact PwC to for assistance in filing claims for refunds of French withholding taxes suffered since 1 January 2009.

A number of other key EU countries including Austria, Belgium, Denmark, Finland, Germany, Italy, Spain, and Sweden similarly subject investment funds to discriminatory dividend withholding taxes and this new Court ruling clearly opens up the opportunity for funds to safeguard their rights and file refund claims within the applicable local statutory time limitations ranging from 3 months to 5 years.

Contacts

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