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ESTONIA

Court of Appeal holds Estonian withholding tax on outbound dividend payments incompatible with EC Treaty

Facts of the case

On November 25, 2009, the Tallinn District Court (Court of Appeal) in Estonia concluded that the withholding tax on outbound dividends is incompatible with the EC Treaty. The case has now been appealed by the tax authorities at the Supreme Court of the country.

In the case at hand, an investment fund (UCITS) established under Luxembourg law as a legal entity, owned shares in an Estonian resident corporation and received dividends in 2004 and 2005. Dividends distributed to a non-resident having less than 20 percent participation in an Estonian legal entity were subject to a withholding tax. The fund claimed that the situation where tax was withheld from dividends paid to a foreign investment fund was in violation of Articles 56 and 58 of EC Treaty as there was no tax withheld from dividends paid to a domestic UCITS.

Background

As in Estonia, UCITS can only be established as a contractual fund, and the Luxembourg UCITS was a legal entity, the dispute relates to whether the foreign fund established as a legal entity should be compared to an Estonian domestic fund established as a (non-taxable) contractual fund (i.e. pool of assets) or to a (taxable) Estonian legal entity. Previously, the Tallinn Administrative Court (Court of First Instance) found that the comparison should be made purely on the legal status of the entity and found that no incompatibility with EC Treaty exists. The Court of Appeal, however, found that the comparison based on the economic functions performed by the funds should be taken as the basis to determine whether the free movement of capital is violated or not. Taking such comparison as the basis, the District Court observed that there was difference in treatment.

Court's decision

In respect of justifications, the court analysed whether the restriction on the free movement of capital can be justified by the necessity to safeguard the cohesion of the tax system and the division of taxing rights between the Member States. Interestingly, here the court also found it necessary to determine how the unit holders are taxed in Estonia. It found that a difference in timing of taxation could only be justified by the cohesion of the tax system and would as such be proportionate. However, the court found that if investments by non-residents to an Estonian company are made through an Estonian UCITS, such income is to be taxed neither at the level of Estonian fund nor at the level of the non-resident unit holders. At the same time, investments made by Luxembourg UCITS would be subject to a withholding tax. The Court con-

cluded that such burdensome taxation of a fund of another Member State cannot be justified by the necessity to safeguard the cohesion of the tax system and the division of taxing rights between the Member States. The Court of Appeal did not find any justifications and concluded that the withholding tax on outbound dividends is incompatible with EC Treaty.

Status

The case has now been appealed by the tax authorities at the Supreme Court, who should decide whether to refer it to the ECJ or whether the case is sufficiently clear to make the decision themselves.

Comments

In conclusion, the main question at stake that the Supreme Court would need to solve, relates to the right comparability:

- If LuxSICAV¹ would be compared to an Estonian fund established as pool of assets (which are not taxable), the authorities seem to agree there is a discrimination; however
- If LuxSICAV would be compared to an Estonian fund having a form of a legal entity (which is subject to tax in Estonia), the authorities are of the opinion that levying the tax on non-residents (through withholding) does not put them in a less favourable situation as also local funds having a form of legal entity are subject to tax (by self-assessment).

However, if the second comparison would be made (as was done by the Court of First Instance), the Court should still to determine, whether there may also exist the discrimination on the basis of:

- The tax rate difference (withholding tax is levied at the rate of the year when non-resident receives dividends i.e. at 26 percent in 2004 and 24 percent in 2005, but due to the characteristics of Estonian corporate tax system, the residents pay corporate tax at a rate of the year when they decide to distribute dividends - rate has lately gradually decreased from 26 percent to 21 percent and residents could therefore pay tax at a much lower rate);
- Cash-flow difference (withholding tax is levied immediately while due to the characteristics of Estonian corporate tax system, the tax due from residents can basically be deferred for unlimited period);
- Tax basis difference (withholding tax on non-residents is levied on a gross basis, while taxation of residents takes place on a net basis i.e. resident companies can also deduct any expenses related to earning the dividend income).

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NOTES

¹ A SICAV is an open-ended collective investment scheme common in Western Europe especially in Luxembourg, Switzerland, Italy, Belgium, France and Spain. SICAV is an acronym for Spanish *sociedad de inversión de capital variable* or French *société d'investissement à capital variable*, which can be translated as 'investment company with variable capital'.