

Newsflash

EU Direct Tax Group

NF 2009 / 040



1 December 2009

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Estonia – Court of Appeal decides that withholding tax on outbound dividend payments is incompatible with the EC Treaty

On 25 November 2009, the Tallinn District Court (Court of Appeal) concluded that the withholding tax on outbound dividends is incompatible with the EC Treaty.

In the case at hand, an investment fund (UCITS) established under Luxembourg laws 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% 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 EC Treaty because there was no tax withheld from dividends paid to a domestic UCITS.

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 fund established as a (non-taxable) contractual fund (i.e. pool of assets) or to a (taxable) Estonian legal entity. Previously, the Court of First Instance found that the comparison should be made purely on a legal status of the entity and found that no incompatibility with EC Treaty exists.

The Court of Appeal, however, found that the comparison made based on the economic functions the funds are performing, should be taken as a basis to determine whether the free movement of capital is violated or not. Taking such comparison as a basis, it found indeed that there was different treatment.

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 found it also necessary to determine how the unit holders are taxed in Estonia. It found that if there would only be a difference in timing of taxation, this could be justified by the cohesion of the tax system and it would be proportionate. However, 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 did not find any justifications and concluded that the withholding tax on outbound dividends is incompatible with EC Treaty. It is not yet clear whether the case will be appealed by the authorities at the Supreme Court.

Previously, on 13 May 2008, the District Court had concluded that the case at issue may justify a request for a preliminary ruling from the ECJ and gave the parties until 10 June 2008 to present their views on the questions to be submitted to the ECJ, but it suspended the proceedings until a decision in the case C-303/07 (*Aberdeen Property Fininvest Alpha*) was made.

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