

PwC Japan Tax Newsletter

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'Fokus Bank' - reclaim of dividend withholding tax

The European Community (EC)¹ treaty contains an express prohibition of national laws which restrict the free movement of capital between "Member States and third countries".

Over the last few years this rule has been subject to numerous judgments of the European Court of Justice (ECJ)², and for the fund management industry this principle is applied such that it now seems that the free movement of capital applies to investors based outside the European Union (EU)³ making portfolio investments into Europe. This broader applicability of the free movement of capital may create opportunities for non-EU resident investors including Japanese investors to file refund claims in respect of withholding tax suffered on their portfolio investments around Europe.

This August edition issue will introduce the first dividend reclaim case in Europe, known as the 'Fokus Bank' claim, and its development over the past few years. It will then go on to discuss the potential application of the 'Fokus Bank' claim to Japanese portfolio investors who invest in EU or European Economic Area (EEA)⁴ companies. Further developments may arise in respect of potential claims and this newsletter is designed as an up-to-date summary of the present practice and potential approach for Japanese investors.

1 The European Community (EC) is the first of the three pillars of the European Union formalized under the Maastricht Treaty (1992/3). It is based upon the principle of supra-nationalism and has its origins in the European Economic Community, the predecessor of the European Union. Member states included France, Germany, Italy, Belgium, the Netherlands and Luxembourg, Denmark, Ireland, United Kingdom, Greece, Spain and Portugal.

2 The Court of Justice of the European Communities, usually called the European Court of Justice (ECJ), is the highest court in the European Union in matters of European Community law. It has the ultimate say on matters of EU law in order to ensure its equal application across all EU member states.

3 The European Union (EU) is an economic and political union of 27 member states. Committed to regional integration, the EU was established by the Treaty of Maastricht on 1 November 1993 upon the foundations of the pre-existing EC. The member states are Austria, Belgium, Bulgaria, Cyprus, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, and the United Kingdom.

4 The European Economic Area (EEA) was established on 1 January 1994 following an agreement between member states of the European Free Trade Association (EFTA), EC, and all member states of EU. It allows these EFTA countries to participate in the European single market without joining the EU. Member states are Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Liechtenstein, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Norway, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden and United Kingdom.

Background

Article 56 of the EC treaty⁵ provides that:

“all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited.”

So far as taxation is concerned, the ECJ has over a number of years handed down judgments from which it is clear that:

- The payment of a dividend and interest is a movement of capital.
- A withholding tax on a non-resident recipient is a prohibited restriction where a resident recipient of the same dividend or interest payment would not have suffered the same effective tax burden on the dividend or the interest payment, either withholding tax or corporate income tax. That is to say, outbound dividends or interest payments cannot be subject to higher taxation than domestic dividends.

EU-based investment funds, pension funds and life insurance companies may be subject to dividend withholding taxes when they invest in the shares of companies' resident in other EU member states or in EEA countries, whereas a comparable domestic fund or life company generally does not suffer withholding tax or receives a refund of the tax withheld.

The issue of incompatibility of such withholding taxes with European law was first considered in the *Fokus Bank case*⁶, where the Court of European Free Trade Association (EFTA)⁷ ruled that it was discriminatory for Norway to withhold tax on dividends to UK and German investors while effectively exempting Norwegian investors from the same taxation.

Since the *Fokus Bank* case in 2004, a sizeable number of EU based pension funds, investment funds, insurance companies, charities, government-owned organizations, etc., have filed refund claims with the purpose of reclaiming withholding tax on dividends and interest payments levied in past years.

In addition the ECJ has had the opportunity to develop its own case law based on the EFTA court judgment in *Fokus Bank* and has consistently followed the same principle. Most recently, the ECJ considered a case where the recipient was a Luxembourg *Société d'investissement à Capital Variable* (SICAV) investment fund and made a number of important rulings in the taxpayer's favor. At the same time that the judicial precedent has advanced to the advantage of taxpayers, some of those entities that submitted protective claims have received substantial repayments from certain European countries.

Third country residents

It is clear from its wording that Article 56 EC has application to dividends and interest payments paid by a company resident in the EU to a resident in a third country.

There are, however, certain caveats to the broader application of this rule, namely:

- The dividend or interest payment must be paid in respect of a portfolio investment.
- For there to be any merit in a third country resident filing a protective reclaim, there must be an effective exchange of information clause in the double tax treaty between the paying and recipient states.

⁵ The EC treaty refers to the Treaties establishing the European Communities and certain related acts, which were, together with the Treaty of the European Union (signed at Masstricht in 1992), as amended by The Treaty of Amsterdam, signed on 2 October 1997, and entered into force on 1 May 1999.

⁶ *Fokus Bank ASA v the Norwegian State*, November 23, 2004, EFTA Court.

⁷ The EFTA Court, formally the "Court of Justice of the European Free Trade Association States," is a supranational court covering the three European Free Trade Association (EFTA) members who are also members of the European Economic Area (EEA): Iceland, Liechtenstein and Norway.

Whilst there is, as yet, no ECJ judgment that deals expressly with third country residents, the case law which has developed to date in relation to third country issues and other recent developments seems to indicate that there is merit in third country residents submitting protective claims for the recovery of withholding taxes levied contrary to EU law.

Who can claim?

The extension to third country residents potentially applies to all portfolio investors, such as:

- Investment funds
- Pension funds
- Charities or endowments
- Insurance companies
- Sovereign wealth funds

Technical analysis

The key consideration in the context of third country claims is whether dividends paid to and received from third country residents can be brought within the scope of Article 56 EC. A two step analysis should be made in order to establish a viable case for third country claimants:

1. There should be a 'portfolio investment' as opposed to 'direct investment'.
2. The legal framework underlying the dividend transactions should be comparable to that which governs EU/EEA member countries' domestic and/or intra- EU/EEA transactions. Specifically, there should be a double taxation convention between the third country and the EU/EEA member state with a suitable exchange of information article, which allows for the exchange of information necessary for carrying out the domestic laws of the treaty states concerning taxes.

Implications for Japanese investors

Prima facie, it is likely that the above two conditions would be met with regard to the Japanese portfolio investors, e.g., Japanese pension funds and investment funds, which invest in the EU/EEA companies. However, it is important to ensure that the most updated Japan treaties with the EU/EEA states contain a sufficient exchange of information article as discussed above.

Nevertheless, there remain some open questions, including as to: (i) whether there may be further complications for Japanese claimants since often they invest in European companies via foreign and domestic contractual investment funds (ranging from Japanese investment trusts to such vehicles as Luxembourg domiciled *fonds cummun de placement* or SICAV and Cayman or Irish unit trusts or companies) that are not generally regarded as fiscally transparent for Japanese tax purposes nor necessarily Japanese investment vehicles; and (ii) whether asset managers can make collective claims on behalf of their investors or the investment vehicle itself. Such questions would need to be addressed in the consideration of, and, if proceed, the subsequent process of filing potential reclaims.

Finally, and just as applicable to Japanese claimants as elsewhere, before filing protective reclaims with the relevant taxation authorities, potential third country claimants should, as a first step, undertake a cost benefit analysis bearing in mind not only the amounts of withholding tax at stake, but also that some analysis will be required on a country by country basis to determine the comparability of the claimant entity with the appropriate domestic entity and consequently the degree of discrimination.

For more detailed information, please do not hesitate to contact your financial tax services representative or any of the following members:

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