

Investment Management

The European Commission decides to refer five EU Member States to the European Court over withholding tax discrimination

The European Commission considers the rules on taxation of outbound dividends in Belgium, Spain, Italy, the Netherlands and Portugal to be discriminatory and contrary to the EC Treaty and the EEA Agreement. This development is of considerable importance to investment funds, pension funds and life insurance companies that invest in European equities.

Background

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

The European Commission considers that rules that lead to the higher taxation of outbound dividends than of domestic dividends may be contrary to both the EC Treaty and the EEA agreement as they restrict both the free movement of capital and the freedom of establishment.

The Commission sent a formal letter to Belgium, Spain, Italy, the Netherlands and Portugal on 25 July 2006, requesting them to change their withholding tax legislation concerning outbound dividend payments to companies in relevant jurisdictions. This request was in the form of a Reasoned Opinion under Article 226 of the EC Treaty. Each country had two months to respond to the Commission.

In response, the Netherlands modified its legislation for future years, but only for dividends paid to pension funds resident in other EU Member States. Belgium, Italy and Portugal did not provide an effective response to the Commission, and Spain's reply was negative.

Latest development

The Commission has announced its decision to refer all five Member States to the European Court of Justice (ECJ). However, in the case of the Netherlands, the referral concerns just dividends paid to those EEA /

EFTA countries which provide appropriate assistance.

The process now expected is that the Commission will submit a referral application to the ECJ, which takes approximately one year to get listed for hearing. Based on recent ECJ cases, it is then expected to be approximately two years before a judgment is handed down.

Implications of the referral

On 14 December 2006, the ECJ issued its judgment in the *Denkavit* case, and found in favour of the taxpayer. While the ECJ confirmed the principle that outbound dividends cannot be subject to higher taxation in the source State than domestic dividends, the ECJ considered that it may be relevant to take into account whether the State of residence of the recipient gives a tax credit for the withholding tax levied by the source State.

The Commission has indicated that it will take this factor into account when drafting the applications to the ECJ. Until now, the Commission is considered to have followed the same approach as the EFTA Court in the *Fokus Bank* case, where it was explicitly ruled that it is was not relevant whether a tax credit was given in the State of residence of the recipient.

It is noted that the Commission has not yet sent a similar request to France or Germany. It is possible that in the case of France, the Commission is expecting France to amend its withholding tax legislation following the judgement in the *Denkavit* case, which concerned two French companies paying dividends to a Dutch company. However, we are not aware of any announcements being made in this regard by the French Ministry of Finance.

Other relevant developments

Luxembourg

The Commission also sent a Reasoned Opinion to Luxembourg on 25 July 2006. As Luxembourg decided to end its tax discrimination (which only concerned EFTA countries which provide appropriate assistance), the Commission has stated that the case against Luxembourg will be closed as soon as it has made the necessary changes to its tax rules.

Latvia

The Commission has subsequently also sent a Reasoned Opinion to Latvia concerning discriminatory taxation of outbound dividend payments to companies. If Latvia does not respond satisfactorily within two months, the Commission may refer the matter to the ECJ.

How PwC can help

In 2004, PwC identified the opportunity for investment funds, pension funds and life companies to reclaim EU dividend withholding taxes. We formed the PwC Fokus Club through which we have assisted our clients with filing protective tax reclaims in 12 European jurisdictions for the recovery of EU withholding taxes.

Given this development with the Commission and recent ECJ judgments, funds and life

companies investing in equities in EU or EEA Member States may wish to consider filing protective reclaims with the relevant taxation authorities to reclaim dividend withholding taxes suffered.

Following the ECJ Judgment of 12 December 2006 in the *Test claimants in the FII Group Litigation Order* case, UK investment funds should also consider parallel action of resubmitting tax returns to HM Revenue & Customs on the basis that the UK tax rules on the taxation of EEA dividends received by UK shareholders owning less than 10% of the voting rights of an EEA company are discriminatory.

By taking action, a fund could increase its investment returns by 40-60 basis points as well as obtain a substantial one-off boost to the fund for taxes paid in years within the statutes of limitation of the relevant Member States.

Contacts

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