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ECJ - denial of withholding tax exemption to US fund incompatible with EU law

On 10th April 2014, the ECJ gave its decision in the DFA Emerging Markets case (C-190/12). It ruled against a Polish tax law which withheld tax on dividends paid to foreign investment funds, while exempting dividends paid to Polish investment funds. The ECJ ruled that the Polish legislation cannot exclude non-EU investment funds from the withholding tax exemption if appropriate exchange of information arrangements are in place between Poland and the US.

ECJ decision in brief

After having concluded that

- US investment funds are in a situation which is objectively comparable to that of investment funds whose registered office is situated in Poland;
- There is no need to preserve the coherence of the tax system as there is no direct link between the withholding tax exemption on dividends to Polish investment funds and the taxation of those dividends as the income of unit-holders in that investment fund; and
- information exchange arrangements are in place between Poland and the US (article 23 of the Double Tax Treaty concluded between both countries and the 1988 Mutual Assistance Convention to which Poland and the US are parties);

the ECJ ruled that the Polish legislation at stake is to be considered as not compatible with the EU principle of free movement of capital (as stated in article 63 of the Treaty on the Functioning of the European Union) provided Poland and the US are subject to mutual administrative assistance rules which enable the Polish tax authorities to verify any information which may be transmitted by the investment fund. The ECJ rejected claims made by Poland and other member states that the different regulatory framework (US funds not being subject to the EU UCITS directive) allows Poland to distinguish EU and non-EU investment funds. The Advocate-General had entertained this claim in his opinion in this case; however, in rejecting the claim, the ECJ rightly pointed out that this would empty Art 63 of its non-EU scope.

The ECJ confirmed the existence of exchange of information agreements between the 2 countries, however it returned to the national court (Polish in this case) the consideration of whether the exchange of information is sufficient to allow the Polish tax authorities to establish the equivalence of the US funds and the Polish funds. It still remains to be seen whether the Polish Courts, or other national courts if asked, will come to the conclusion that these agreements enable the tax authorities to verify the information provided by US investment funds on the conditions for their formation and operation, in order to determine whether they operate within a regulatory framework equivalent to the one applicable in the EU.

Finally, the ECJ ruled that the request of Poland to limit the effects in time of this judgment cannot be granted, meaning that the decision will have unlimited retroactive effect, allowing claims within the Polish statute of limitations and possibly with some scope to extend further using so called "state liability" principles.

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Implications

This decision is good news for investment funds located in third countries like the US or Canada, as it confirms that non EU/ third country investment funds may benefit from the same principles as EU investment funds under certain conditions.

It will be interesting to see how this case affects the current law and practice of some EU States that have been using the same arguments, now rejected by the ECJ, to obstruct non-EU funds making claims for refunds or exemption at source. It is likely that some States will continue to fight rearguard actions on more or less tenuous grounds, but this decision is a significant step towards removing the discrimination against non-EU funds.

Atoz and our Taxand colleagues in 12 countries around Europe are leaders in this matter and will continue to be at the forefront of helping our clients handling claims and litigating where required.

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