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# Report to the European investment funds industry

## Discriminatory tax barriers in the single European investment funds market: a discussion paper

June 2001

## Note from the author

I often hear speakers at conferences refer to tax as a significant barrier to the development of a single market for UCITS[1] – which it is. I was therefore delighted when Steffen Matthias, Pierre Bollon and Sheila Nicoll of FEFSI[2] asked me to analyse and report back on this subject. As far as I am aware this report is the first comprehensive analysis of this subject in the European Union.

A key message in this report is that these barriers can be dismantled, and quite swiftly, because most (and probably all) of them are in breach of the European Treaty. National Fund Associations, individual national governments and the Commission therefore have the legal framework in existence which is necessary for change to take place.

Why do these barriers matter? The most compelling answer to this is probably that these (and other) barriers lead to higher costs for fund sponsors and consumers. A reduction in tax barriers could allow the single market in investment funds to work more effectively. Reducing the tax barriers highlighted in this report is therefore a very important issue.

In writing this report I have received valuable assistance from a number of sources, though any oversights or mistakes are mine. I would particularly like to acknowledge and thank the following:

- Steffen Matthias – Secretary General of FEFSI
- Pierre Bollon, Annick Montel and Bénédicte Vincent – of the French Fund Industry Association, AFG-ASFFI
- Members of the FEFSI tax committee
- Allan Pelvang of Fidelity
- Charlotte Worthington at PricewaterhouseCoopers London who researched cases and obtained and collated data on the European market
- Andrea Myles who persevered with numerous changes and diagrams
- Various colleagues of mine at PricewaterhouseCoopers around Europe including Gerald Schwab (Austria), Raimo Hietala (Finland), Murielle Colart and Jean-François Lycops (Belgium), Birgitte Tabbert (Denmark), Jacques-Hubert Diner (France), Katja Meyer and Charlotte Worthington (Germany), David Lawless (Ireland), Lorenzo Banfi and Francesco Mantegezza (Italy), Laurent de la Mettrie (Luxembourg), Jorge Figueiredo (Portugal), Miguel Blasco and Beatriz Morilla (Spain) and Pia Gustagson (Sweden).

Please feel free to contact Steffen Matthias of FEFSI (Tel: (+32) 2 513 39 69 or E-mail: info@fefsi.be) or me (Tel: (+44) 207 804 2039 or E-mail: david.newton@uk.pwcglobal.com) if you would like to add to, disagree with or discuss this report. All contributions will be gratefully received.

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June 2001

1 UCITS are investment funds formed in one EU Member State complying with Directive 85/611/EEC. Such UCITS, once registered can be sold around the European Union with no further licensing requirement in the country of sale

2 FEFSI, the *Fédération Européenne des Fonds et Sociétés d'Investissement,* represents the interests of the European investment funds industry. Through its members, the national associations of the 15 EU Member States, the Czech Republic, Hungary, Norway, Poland and Switzerland, FEFSI represents some 900 management companies and over 36,000 investment funds with EUR 4.6 trillion in investment assets.

*Front cover: Reichstag Dome, Berlin*

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# Report by PricewaterhouseCoopers to the European investment funds industry

# Discriminatory tax barriers in the single European investment funds market: a discussion paper

## Part I

### Objectives

It is apparent to anyone operating in the European Union investment funds industry that the separate and diverse taxation rules in each EU Member State can frustrate the development of the cross-border investment funds industry within the EU. Whilst this subject is frequently discussed there has been no real attempt to systematically analyse the position in each EU Member State. To rectify this FEFSI[1] commissioned this report so that the true position in each EU Member State could be reviewed and analysed.

The objectives of this report are to:

- provide a provisional analysis of the specific tax rules in each country which are discriminatory either because they penalise the foreign UCITS[2] product or favour the home country UCITS product;
- analyse the structure of the European Union (so far as relevant to the funds industry) and the obligations of EU Member States under the European Union Consolidated Treaty (the Treaty).

This report focuses only on discriminatory tax provisions which adversely affect the cross-border sale of UCITS. It does not deal with other types of investment fund or financial services products (such as banking facilities or insurance policies).

It should be noted that not all types of tax related discrimination can be challenged under the provisions of the Treaty. EU Member States can for example implement tax rules which discriminate against their own home country UCITS and favour those funds sold by foreign managers into their own country. The Luxembourg net asset tax or stamp duty provisions for UK investment managers might be examples of such discrimination. Unfortunate though these measures might be for those affected they cannot be challenged under the provisions of the Treaty. This is because the Treaty provisions only apply to discrimination that seeks to frustrate the sale of foreign (i.e. non domestic) UCITS, and do not have any application when a Member State (perversely) penalises its own home country UCITS.

There are of course other types of non-tax related administrative burdens which can frustrate the sale of foreign UCITS in the EU, for example local regulatory hurdles and marketing rules. Whilst these can sometimes give rise to discrimination which can be challenged under the provisions of the Treaty, this report highlights only tax related measures. FEFSI is preparing a separate report on regulatory and marketing rules in the EU.

This report refers to various tax laws and cases in individual countries and includes all law changes up to April 2001.

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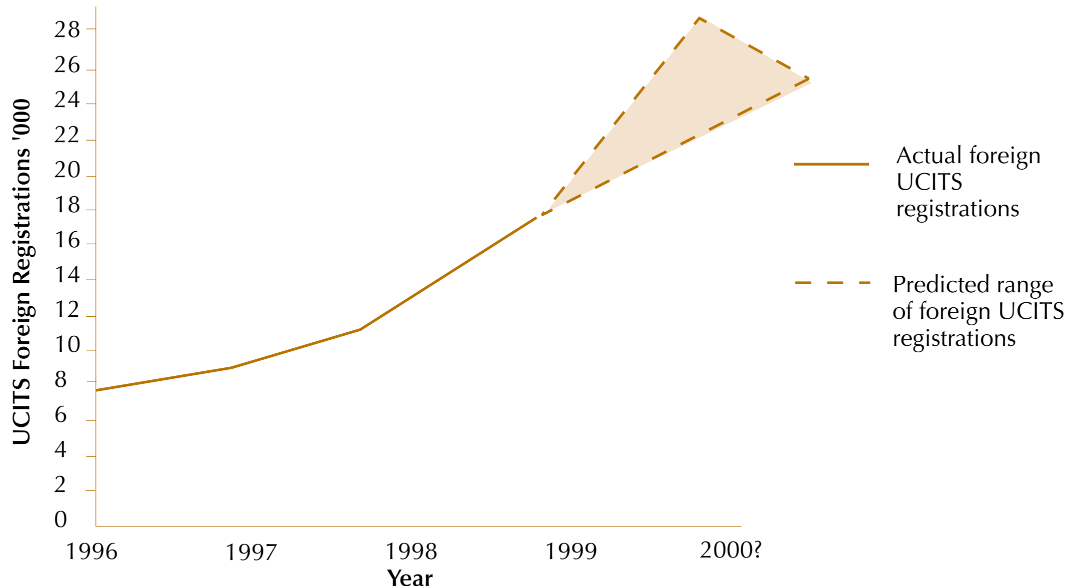
1 FEFSI, the *Fédération Européenne des Fonds et Sociétés d'Investissement,* represents the interests of the European investment funds industry. Through its members, the national associations of the 15 EU Member States, the Czech Republic, Hungary, Norway, Poland and Switzerland, FEFSI represents some 900 management companies and over 36,000 investment funds with EUR 4.6 trillion in investment assets.

2 UCITS are investment funds formed in one EU Member State complying with Directive 85/611/EEC. Such UCITS, once registered can be sold around the European Union with no further licensing requirement in the country of sale.

# Executive summary

- The UCITS Directive, which was adopted in December 1985, has in many respects been very successful in promoting the growth in sales of investment funds on a cross border basis around the European Union.
- The chart below shows the growth in foreign registrations of UCITS over the years up to 1999:




*Source: Lipper & PwC*

- Whilst it is clear that there is an emerging single market in UCITS it is also clear that promoters of these funds are discouraged by national tax rules from selling UCITS in particular countries. In some cases fund managers live with these difficulties and in the very worst case the result is that virtually no UCITS are sold into the country. An example of the latter would be Denmark.
- These taxation barriers are undoubtedly one of the reasons why the EU single market in UCITS has not developed even more rapidly. This is one of the reasons why average fund sizes are smaller than might otherwise be the case and this is likely to lead to higher costs for fund sponsors, managers and consumers.
- The UCITS Directive itself is silent with regard to taxation. EU Member States remain responsible for their own direct tax rules. These direct tax rules deal, inter alia, with the taxation of foreign investment products sold into their country, the taxation of investors who hold such UCITS and tax reliefs that may be available for investment into certain UCITS.
- Even though Member States retain the responsibility for direct tax legislation, it is established European Union case law that:

  *"although as Community law stands at present direct taxation does not fall as such within the purview of the Community, the powers retained by Member States must nevertheless be exercised consistently with Community law[3]" and Member States shall "therefore avoid any overt or covert discrimination on grounds of nationality[4]".*

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3 Case C-279/93, Finanzamt Koln – Altstadt v Schumacker 1995 ECR 1–225 para 21

4 Futura Participations SA and Singer v Administration DES Contributions 1997 ECRI-2471

# Executive summary (continued)

- The Treaty enshrines the principle that restrictions on the freedom to provide services shall be prohibited, as shall all restrictions on the movement of capital between the Member States. The sale of a UCITS is both the supply of a service and, from the investor viewpoint, a movement of capital. Sales of UCITS into a foreign country will therefore be covered by these provisions of the Treaty.
- To the extent that national tax rules frustrate the sale of UCITS into a particular Member State, these tax rules may be challenged under the Treaty through the European Court of Justice. Similarly, tax rules that give relief to investors in a domestic UCITS but not to the same investors investing in a foreign UCITS may also be challenged in the European Court of Justice.
- Whilst EU Member States can under the Treaty justify discriminatory tax measures, broadly, on public interest grounds, the European Court of Justice has been increasingly prepared to decide that a tax rule that conflicts with the fundamental freedom to provide services or the free movement of capital will be struck down.
- Whilst particular tax cases can be taken to the European Court of Justice initially through the national courts, this is a costly and time consuming process – although if the action is successful, costs may also be awarded against the Member State concerned.
- A much more satisfactory route would be to encourage the European Commission to use its powers under the Treaty firstly to challenge Member States in relation to tax barriers that are thought to be contrary to the Treaty and secondly if a satisfactory conclusion is not reached to refer the case to the European Court for adjudication.
- As this report highlights and the table below demonstrates, there are in some EU countries significant tax barriers, which are to a greater or lesser extent frustrating the sale of UCITS into those territories. In researching the list below we have included only those measures that appear to us to represent significant barriers.

## Countries with significant discriminatory tax barriers to the sale of foreign UCITS in their territory:

| Country | Description of discriminatory tax measure |
|---|---|
| Austria | Existing income tax regime |
| Belgium | i. Tax on distributions to individual investors<br>ii. Participation exemption<br>iii. Benefit from foreign tax credits |
| Denmark | Foreign Fund legislation |
| Finland | None noted |
| France | i. Plan d'Epargne en Actions ('PEA')<br>ii. Franchise relief<br>iii. French imputation tax system |
| Germany | i. Existing foreign investment fund law<br>ii. New tax reform measures |
| Greece | Investment funds legislation which penalises foreign UCITS |
| Ireland | Taxation of Irish investors in offshore UCITS |
| Italy | Capital gains tax |
| Luxembourg | None noted |
| Netherlands | Reclaim of foreign withholding taxes |
| Portugal | Different income tax regimes for individual investors |
| Spain | None noted |
| Sweden | None noted |
| UK | i. Offshore fund legislation<br>ii. UK Imputation tax system |

*Source: PricewaterhouseCoopers*

- It is hoped that by highlighting these discriminatory tax barriers in the EU that pressure for change can be exerted on national governments and the European Commission.

# Part II

## The UCITS Directive - the single market aspiration

The UCITS Directive[5] was one of the very first financial services related directives to be adopted back in December 1985 for introduction into national laws.

The purpose of the Directive was to facilitate the cross-border participation in certain collective investment undertakings or investment funds. Each Member State had (and continues to have) its own form of these investment funds. The Directive sets out those investment funds that will qualify as UCITS under the Directive and can be marketed in other Member States.

In the years since the Directive came into force there has been a steady growth in the sale of UCITS sold on a cross-border basis. At the end of 1999 UCITS that were marketed outside their country of domicile into one or more Member States had achieved a market share of around 30% of the total European Union investment fund market. The biggest beneficiary of this trend has been Luxembourg and around 80% of all the UCITS marketed on a cross-border basis are domiciled in Luxembourg.

## Tax barriers can be challenged

The steady reduction in barriers to the achievement of a single market in investment funds has had the effect of increasing the focus on the remaining impediments to the smooth operation of the single market.

Without question taxation remains an important barrier and the purpose of this report is to draw attention to these barriers and to the fact that many of them would, if challenged in the European Court of Justice, almost certainly be judged to be contrary to the European Union Consolidated Treaties.

## The European Union and direct taxes

The UCITS Directive itself is silent about taxation. Consequently it is necessary to look to the underlying framework of the European Union if tax barriers in particular countries are to be challenged.

The EU framework is governed by a series of treaties that have been agreed by Member States. These have now been consolidated into the European Union Consolidated Treaties ("the Treaty"). It is important to note that the Treaty contains no specific mandate enabling the European Commission to bring forward measures for the harmonisation of direct taxes. [By contrast Article 93 does provide for the Commission to bring forward provisions for the harmonisation of indirect taxes (e.g. turnover taxes, excise duties and other indirect taxes)].

Some direct taxation measures introduced by the European Commission (such as the proposed Savings Tax Directive) are brought forward on the basis of Article 94, which envisages that the Council of Ministers may unanimously approve directives:

> *"for the approximation of such laws, regulations … as directly affect the establishment or functioning of the common market".*

[5] The Directive for Collective Investment in Transferable Securities (UCITS) was approved by the Council of the European Communities on 20 December 1985 (Directive number 85/611/EEC). The Directive provided that with the exception of Greece and Portugal Member States should have introduced the relevant national laws, regulations or provisions pursuant to the aims of the Directive no later than 1 October 1989. In the case of Greece and Portugal the date for implementation of the directive was 1 April 1992.

As is well known, direct tax measures such as the proposed Savings Tax Directive also require unanimous approval of all Member States.

## Grounds for challenging tax measures

From the analysis above it would appear that the prospects for eliminating direct tax measures that frustrate the development of the single market in UCITS are slim.

This is in fact not the case. The grounds for challenging tax barriers lie elsewhere in the Treaty. In particular, there are provisions relating to the free movement of services and capital within the European Union. To the extent that tax rules conflict with these, the tax rules giving rise to the barrier may be capable of being challenged under the Treaty.

Unfortunately such challenges frequently require a trip to the European Court of Justice which is both time consuming and costly. Once there, however, it is established case law that:

> *"although as Community law stands at present direct taxation does not fall as such within the purview of the Community, the powers retained by Member States must nevertheless be exercised consistently with Community law[6]" and Member States shall "therefore avoid any overt or covert discrimination on grounds of nationality[7]".*

It is accepted case law therefore that tax measures that discriminate on grounds of nationality (perhaps by applying different rules to investment funds domiciled outside the home country) may be subject to challenge. Although this is established EU law, the boundaries of this general principle are still being defined in the European Court of Justice and therefore such cases are likely to be referred by a national court to the European Court of Justice for determination.

The grounds for raising a successful challenge against a particular piece of domestic tax legislation are dealt with below.

## European Court of Justice takes a harder line…

It is important to note that the European Court of Justice has in recent years been taking a harder line against tax measures that discriminate on grounds of nationality, domicile or residence.

The acceptable defences on the basis of which Member States may seek to argue for particular tax measures have been narrowed and consequently, where a particular tax measure impinges upon the freedom to provide services or to move capital around the European Union, the courts will generally strike down the tax measure concerned.

This trend has not gone unnoticed by various Member States and this is having an impact on the drafting of new legislation. Unfortunately this is not universally the case as evidenced by "tax reform" measures introduced in Germany in 2001 which are clearly discriminatory, as discussed further below.

Many of the measures which are identifiable as discriminatory later in this report date from a period before the current consolidated Treaties came into force. It is worth noting that some of the single market freedoms which we now take for granted are relatively recent developments. For example Member States were only required to implement measures to enable the free movement of capital by 1 July 1990[8].

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6 Case C-279/93, Finanzamt Koln – Altstadt v Schumacker 1995 ECR 1–225 para 21

7 Futura Participations SA and Singer v Administration DES Contributions 1997 ECRI-2471

8 Article 6 (1) of directive 88/361 provides that "Member States shall take measures necessary to comply with this directive no later than 1 July 1990. They shall forthwith inform the Commission thereof. They shall also make known by the date of their entry into force at the latest, any new measure or amendment made to the previous provisions governing capital movements listed in annexe one".

To an extent, therefore, it is inevitable that there will be a conflict between the recently developed single market framework for services and movements of capital on the one hand and tax rules on the other which have been drawn up for essentially domestic purposes over a considerable period in the last century.

## Treaty provisions which forbid tax measures that discriminate against foreign UCITS

Any arguments that a particular tax measure affecting UCITS is discriminatory and can be successfully challenged in the European Court of Justice will generally flow from the provisions of either Article 49 (freedom to provide services) or Article 56 (abolition of the restrictions on the movement of capital).

There are of course other provisions within the Treaty related to the establishment of a single market (for example the freedom of movement for workers (Article 39). These and other similar provisions may also be used to defeat discriminatory tax measures but are not likely to be relevant in the UCITS arena.

**a) Freedom to provide services – Article 49**

The basic provision in Article 49 is very straightforward and easy to understand. It states that *"restrictions on freedom to provide services within the Community shall be prohibited"*. "Services" in this context includes activities of a commercial character. In the Safir case (summarised in Appendix A), the European Court of Justice accepted that an insurance based investment fund was a "service". Although there has yet to be a European case involving a UCITS, "service" should include the sale of investment services and products such as UCITS by fund managers.

There are a number of caveats (derogations) to this freedom to provide services in Article 49. Article 46 sets out that the basic provision in Article 49 "*shall not prejudice the applicability of provisions laid down by law, regulation or administrative action providing for special treatment for foreign nationals on the grounds of public policy, public security or public health*".

This provision is important because it is being used (generally unsuccessfully) by Member States to justify certain tax measures that are discriminatory.

**b) Free movement of capital – Article 56**

Under Article 56 *"all restrictions on the movement of capital between Member States … shall be prohibited".*

An investment in a UCITS is a movement of capital by the investor into the fund.

In the context of the single market in UCITS it is likely that a particular tax barrier could be argued to be both an infringement of the freedom to provide services and a restriction on the movement of capital. The European Court of Justice may well be asked to adjudicate on whether a particular provision contravenes one or both Articles.

Article 56 is also subject to a few caveats or derogations but in the case of Article 56 (in contrast to Article 46) taxation is specifically mentioned.

In particular in Article 58 it is stated that:

*"the provisions of Article 56 should be without prejudice to the right of Member States:*

*(a) to apply the relevant provisions of their tax law which distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested;*

*(b) to take all requisite measures to prevent infringements of national law and regulations in particular in the field of taxation… or to take measures which will justify it on the grounds of public policy or public security".*

Article 58 is frequently advanced by Member States (also generally without success) to defend discriminatory tax rules, and the European Court's interpretation of this derogation is important in order to gain an understanding of the tax measures that might be successfully challenged.

It would also appear that a country wishing to defend a particular piece of tax legislation may have more mitigating arguments using Article 58 than Article 46.

However, as explained below the concept of acceptable discrimination under both Article 49 and Article 56 is evolving and at this stage of the development of case law it is not easy to discern a trend by the European Court to be more accepting of tax discrimination under Article 56 than under Article 49. The point remains a rather academic one at present.

## Identifying tax rules that are discriminatory

The identification of particular tax measures that are discriminatory may at first sight appear to be relatively straightforward. However in practice the concept of discrimination is a remarkably slippery one and also one that is evolving as a result of successive European Court judgments.

From a review of recent cases it is possible to distil a number of features which are likely to mean that a particular tax rule amounts to unacceptable discrimination.

In the UCITS area such discriminatory tax rules are likely to take two broad forms:

a) measures that seek to apply different and discriminatory tax rules to foreign based UCITS;

b) measures that seek to deliver reliefs from taxation but only for investment into domestically based UCITS.

It is inevitable though that each Member State will require, to an extent, separate tax rules in relation to foreign-based UCITS. However[9]:

*"the difference does not necessarily amount to discrimination. There must be unequal treatment in situations which are identical or comparable".*

Therefore simply having tax rules that treat foreign nationals or investment products from a different Member State differently will not necessarily amount to discrimination which contravenes the Treaty.

What must also be demonstrated is that the tax rules disadvantage the domestic investor in a foreign UCITS (compared to a domestic UCITS), or make it less likely that the foreign UCITS will be attractive to the domestic investor.

## Discriminatory tax measures – some illustrative examples of unacceptable discrimination

Suppose, for example, that there were a different rule for foreign nationals who were resident in the UK investing in a UK PEP[10] than for UK residents. If a foreign national were initially taxable on the income arising in the PEP but then given a relief to put him in the same after-tax position as a UK resident with the

9 Biehl v Administration des contributions du Grand Duche de Luxembourg C-175/88 & Schermers and Waelbroeck "Judicial Protection in the European Communities."

10 A UK PEP is a personal equity plan that allowed UK individuals to invest up to £6,000 per fiscal year in qualifying funds or securities (e.g. a UK authorised unit trust with at least 50% of its investments in qualifying UK or EC shares) and receive income and capital gains tax free. The PEP product was replaced by the ISA (Individual Savings Account) for the fiscal year 2000 onwards.

same investment (who gets a complete exemption) such a tax rule would probably not be unacceptable discrimination provided the end result leads to a broadly equal treatment. (Example A).

On the other hand a tax law that denied any tax exemption or relief to a foreign national who was resident in the UK and invested in a PEP would be directly discriminatory if a similarly placed UK resident with an identical investment were able to obtain an exemption (Example B).

In relation to the sale of foreign UCITS into any Member State, any tax provision that applies a different set of tax rules or procedures when compared to investment in a domestic UCITS is potentially unacceptable discrimination, particularly if some additional burden of compliance is placed on the promoter of the fund or the investor. (Example C) (This was broadly the position in the Safir Case[11].) A tax relief that is available to investors in a Member State if they invest in a domestic UCITS but not if they invest in a foreign UCITS is likely to be regarded as directly discriminatory (Example D).

## Possible defences of the discriminatory tax measures

As direct tax cases have found their way into the European Court of Justice with increasing frequency there has been an impressive degree of ingenuity on the part of Member States in defending discriminatory tax measures.

These are usually built around the provisions of Article 46 (i.e. that there are some public policy issues that take precedence) or under Article 58 where either it is envisaged that there will be different rules for taxpayers not in the same situation as regards their place of residence, where their capital is invested, or generally that the particular discrimination is justified to prevent infringements of national law or on grounds of public policy.

The defences rejected by the European Court include:

a) That allowing a relief to an investor in a foreign company or investment fund would lead to a loss of revenue for a Member State because it cannot tax a foreign company or an investment fund. In the Verkooijen case[12] this was rejected because a *"reduction in such tax revenue cannot be regarded as an overriding reason in the public interest".*

b) That a discrimination is justified because the taxpayer who has suffered the discrimination has in effect obtained another advantage which compensates him for suffering the discriminatory tax measure. For example in Verkooijen[13] a possible justification for a tax exemption on dividends from Dutch companies (which was not available to dividends from non-Dutch companies) was that the taxpayer had suffered less tax in those non-Dutch companies. Such an argument was completely rejected.

c) That the discrimination was directly avoidable because the taxpayer could have reordered his affairs fairly easily to avoid it. This was completely rejected in the Commission v France case[14].

d) That the discrimination is necessary to prevent tax avoidance. This was flatly rejected in the France case: *"furthermore the risk of tax evasion cannot be relied upon in this context. Article 52 (now Article 43) does not permit any derogation from the fundamental principle of the freedom of establishment on such a ground".*

e) That a particular tax measure is justified because without it a Member State cannot ensure that taxation on a foreign investment product (over which the Member State has no control) will be at least as onerous as that on a similar domestic product. This was firmly rejected in the Safir case.

[11] Jessica Safir v Skattemyndigheten i Dalnas, see appendix A for case analysis.

[12] Staatssecretaris van Fimancien v B.G.M Verkooijen C-35/98

[13] For case analysis, see appendix A.

[14] Commission v France C-272/83

f) That the particular tax provision is necessary to pursue certain economic aims of the government. In the case of Svennson[15] it was said that: *"such a discrimination can only be justified on general interest grounds referred to in the Treaty which do not include economic aims".*

## Fiscal coherence

Finally comes the defence which has, to a degree, succeeded. In Bachmann[16], a Belgian tax provision was challenged on the grounds that it discriminated against non-Belgian EU insurers. The provision granted a tax relief to Belgian residents in respect of insurance premiums paid to insurers established in Belgium, while denying the relief in respect of non-domestic insurers. Although the provision was held to be discriminatory, this discrimination was held not to breach Articles 48 and 59 (now Articles 39 and 49) because it was necessary for the *"cohesion"* or *"coherence"* of the Belgian tax system. This was because the proceeds of insurance contracts attracting tax relief on payment of premiums were taxed when ultimately received while those not having attracted tax relief (i.e. premiums paid to foreign insurance companies) were not taxed (in Belgium) when ultimately received. Giving relief to premiums paid to non-Belgian insurers would have made it difficult for Belgium to ensure that ultimate payments from the policy were taxed in the hands of the investor – hence the need to deny relief to ensure overall cohesion.

It is clear from subsequent judgments however that the fiscal cohesion defence is likely to be accepted where only one tax is involved (i.e. income tax) and the particular discriminatory measure is necessary to put one taxpayer standing alone in the same ultimate position as a resident taxpayer.

Many commentators believe that this case, if heard today, would be decided differently.

## Can countries discriminate against their own investment products?

An interesting and fundamental question on discrimination is whether a particular Member State is allowed to discriminate against its own nationals or investment products in favour of foreign ones.

It might seem strange that a government of a particular Member State should allow such a state of affairs to arise but, on reflection, in a competitive world it is entirely possible that a particular country could have, say, a higher tax rate or particular tax which is not present in another Member State. For example Luxembourg levies a net asset tax on Luxembourg domiciled UCITS whereas Dublin UCITS are not subject to any net asset tax. Could a Luxembourg promoter successfully claim that Luxembourg was therefore discriminating against its own UCITS to the detriment of its competitiveness around the European Union when compared with the Dublin product?

The answer would appear to be no. The principal tax case in this area is the Werner case[17]. This was an income tax case under Article 43 (right of freedom of establishment of nationals of a Member State in another Member State). In that case it was held that "the Treaty did not preclude a member imposing a more onerous burden" on its own nationals.

It is interesting to note that had the European Court not decided in this way then it would have been open for any national or entity of an EU Member State (such as the Luxembourg UCITS above) to claim that they were taxed in a more onerous fashion than a foreign entity in a similar position. This really would have set the European Union on the road to tax harmonisation.

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[15] Peter Svensson v Ministre Du Logement et de L'urbanisme C-484/93

[16] Bachmann v Belgian State Case C-204/90

[17] Werner v Finanzant Aachen-Immenstadt Case C-112/91

## Summary – discriminatory tax rules faced by UCITS on a collision course with the Treaty

The overall conclusion from the above is that many of the national tax rules that discriminate against foreign UCITS, or have rules in favour of domestic UCITS only, are on a direct collision course with the fundamental aims of the EU Treaty Provisions covering the freedom to provide services and free movement of capital.

Where such collisions occur, Member States that are taken to the European Court of Justice will have very few defences and there is a trend in the judgments of the European Court to steadily reduce the grounds that Member States may use to justify discrimination.

## Code of Conduct Committee

It has been suggested that the Code of Conduct Review[18] into harmful tax competition might represent a channel through which concerns about barriers to the sale of UCITS could be raised. In the author's view the suggestion that the Code of Conduct Committee could be used in this way is misconceived.

In setting up the Code of Conduct Review the Council noted:

> *"that unrestrained tax competition for mobile forms of business increasingly threatens to cause economic distortions and to erode tax bases within the Community"*

The genesis of the Code of Conduct Review therefore related to concerns that tax measures designed to attract business to a Member State could be harmful and consequently its focus has been primarily on measures designed to attract foreign business to a Member State rather than measures that have the effect of keeping foreign business (i.e. investment products) out of a particular Member State.

Additionally the code was specifically to cover *"those business tax measures which may affect in a significant way the location of business activity in the Community"*. It is unclear that this definition would include tax measures aimed at particular investment products and certainly does not cover individual income tax measures that might be discriminatory.

For all these reasons the terms of reference for that Code of Conduct Committee (as presently constructed) would appear unlikely to be of much help in eliminating discriminatory tax measures in the UCITS area.

## What remedies can the investment funds industry or investors take in respect of discriminatory tax measures?

There have been recent examples of national governments amending rules which are agreed as discriminatory and a number of these successes are highlighted at the end of the report.

Approaching the national governments concerned probably represents the easiest and least expensive route for the industry to pursue and is therefore to be recommended as a first step.

[18] The Council of Ministers of the European Union adopted a resolution on a Code of Conduct for Business Taxation on 1 December 1997. This resolution provided for the establishment of the Code of Conduct Committee to identify tax measures that might be considered harmful. The Council's decision was confirmed on 9 March 1998.

The ultimate remedy in relation to a discriminatory tax measure is a visit to the European Court of Justice. In many respects this is unsatisfactory because it is time consuming and in relation to cases arriving at the Court from the National Courts there is always a risk that costs will not be awarded to the plaintiff. Even if costs are ultimately awarded to the plaintiff against a particular taxing authority there is also the issue of how to fund the cost of the action.

There are broadly two routes by which cases reach the European Court of Justice.

## National Courts

The first is on a referral from the National Courts and would arise where a taxpayer such as Mrs Safir takes a case to a National Court and the National Court refers the case on to the European Court of Justice to make a judgment on the interpretation or validity of the provisions of the Treaty.

For cases to proceed in this way there needs to be a taxpayer against whom the discrimination has occurred and, as many of the cases involving UCITS will centre around an individual taxpayer, it is quite likely that taxpayer would need to be supported financially.

This route is also likely to be the most time consuming since the case needs to find its way through the National Courts and then on to the European Court of Justice. The case is then referred back to the National Court, which applies the interpretation given by the European Court to the case. The time spent for such a case to be decided would depend on a combination of local National Courts around the European Union and the European Court of Justice. Typically the European Court of Justice concludes its review within 18 months of a case being referred to it.

## Role of the European Commission in European Court cases

The second route by which a case may arrive at the European Court of Justice is direct referral by the Commission. Under this route the case bypasses National Courts completely and once it is referred to the European Court of Justice judgment might be expected within two years.

Under Article 226:

> *"If the Commission considers that a Member State has failed to fulfil an obligation under this Treaty, it shall deliver a reasoned opinion on the matter after giving the State concerned the opportunity to submit its observations.*
>
> *If the State concerned does not comply with the opinion within the period laid down by the Commission, the latter may bring the matter before the Court of Justice."*

However before the Commission refers the case to the European Court time will have been spent in a procedure designed to remedy the alleged discrimination without the need for the Court to adjudicate. This procedure involves, inter alia, the Commission notifying the Member State concerned that it believes that an infraction of the Treaty has occurred and inviting the Member State to make comments. If no resolution emerges from this process then the European Commission will set in motion a process to bring the case to the European Court.

Of the two routes, the European Commission route has clear advantages both in time and in cost risk.

In addition, bringing the alleged discrimination to the attention of the Commission enables the process to be started whereby Member States can be challenged and this may enable the matter to be settled without recourse to the Courts.

There are clear advantages therefore for the European investment funds industry in bringing the alleged discriminatory measures against UCITS to the attention of national governments in the European Union and the Commission.

## Action points for FEFSI to highlight tax discrimination

**At its General Meeting in June 2000, FEFSI, therefore, agreed to write to all Member States where tax discrimination has been observed. The basis of such an approach would be the contents of this report. Additionally it was agreed that a copy of this report should also be sent to the European Commission for information and in order to explain the "action" undertaken by FEFSI. In general, it would be made clear that this is not a single action against a single country, but a principled action against tax discrimination for investment funds.**

# PART III

## Individual countries examined

We have set out below a number of measures in relation to European Union Member States that we believe prima facie would be capable of challenge in the European Court on the basis that they are discriminatory and likely to amount to restrictions on freedom to provide services or the movement of capital.

The list below is not an exhaustive list of all discriminatory tax measures facing UCITS but rather ones that have come to our attention and seem to PricewaterhouseCoopers to be the more obviously discriminatory measures.

The aim of the analysis below is not to have provided full case analysis that might be argued with a particular country but to give an overview of the tax legislation concerned.

At a later stage, if representations are made by the Commission to a particular country, further work will be required to assemble a properly argued case in relation to the measure concerned.

As outlined within the executive summary, we have identified the following countries with significant tax barriers to the sale of foreign UCITS in their territory:

| Country | Description of discriminatory tax measure* |
|---|---|
| Austria | Existing income tax regime |
| Belgium | i. Tax on distributions to individual investors<br>ii. Participation exemption<br>iii. Benefit from foreign tax credits |
| Denmark | Foreign Fund legislation |
| Finland | None noted |
| France | i. Plan d'Epargne en Actions ('PEA')<br>ii. Franchise relief<br>iii. French imputation tax system |
| Germany | i. Existing foreign investment fund law<br>ii. New tax reform measures |
| Greece | Investment funds legislation which penalises foreign UCITS |
| Ireland | Taxation of Irish investors in offshore UCITS |
| Italy | Capital gains tax |
| Luxembourg | None noted |
| Netherlands | Reclaim of foreign withholding taxes |
| Portugal | Different income tax regimes for individual investors |
| Spain | None noted |
| Sweden | None noted |
| UK | i. Offshore fund legislation<br>ii. UK Imputation tax system |

*Source: PricewaterhouseCoopers*

*The above includes all tax law changes up to April 2001.

## Austria

- **Existing income tax regime**

Introduced in 1993.

Austria's tax system contains special rules for foreign held assets, which also adversely affect foreign investment funds.

Income derived by a domestic UCITS from domestic shares, domestic and foreign debt securities and bank deposits is subject to a 25 % flat rate withholding tax. No further tax will be payable by the Austrian private investor on distributions received (or interest deemed as distributed) from such source income if the units of the fund are kept in an Austrian bank deposit (no deduction of expenses borne by the investor is possible), and thus the investor suffers a final income taxation rate of 25% on such income from a domestic UCITS. Distributions out of other fund income (e.g. dividend income derived from foreign companies and income derivative products in connection with foreign shares) are taxed at the individual's normal tax rate (up to 50%).

Final income taxation as described above is not granted to investors in foreign funds, regardless of the type and source of income derived by the fund. Consequently all income derived by an Austrian investor into a foreign UCITS is subject to the standard income tax rate of up to 50%, from which expenses of the investor may be deducted. The Austrian investor will be deemed to be taxable on his share of income received by the foreign UCITS, regardless of whether this income is distributed or not.

From 1 January 2001 capital gains realised by private investors in domestic and foreign funds (with an Austrian tax representative, registered for public offering in Austria, and actually offered to the public in Austria) on shares and share derivatives will be taxed at a rate of 5%. A "safeguard tax" (Sicherungsbesteuerung) of 2.5% of the final redemption price of the year will be applied to investors in foreign funds (not domestic funds) who fail to provide the Austrian bank, where the investor holds the units of the foreign fund in a deposit, with their certificate of disclosure to the Austrian tax authorities. This "safeguard tax" is treated as a prepayment of income tax.

The existing income tax law would appear to discriminate against certain foreign UCITS. For these UCITS, the disadvantages arise entirely because of the Austrian tax system. It is feasible that this discrimination could be successfully challenged in the European Court by the promoter of a UCITS disadvantaged in this way, or by an individual investor into the foreign UCITS.

## Belgium

- **Tax on distributions to individual investors**

Introduced in 1994.

It should be noted that UCITS can take two different forms in Belgium: an investment company with legal personality or a collective investment fund which is transparent for Belgian legal and tax purposes.

Under Belgian tax legislation, a Belgian investor receiving a distribution from a Belgian investment company (i.e. a Belgian SICAV) will suffer Belgian withholding tax of 15% on the gross distribution, which represents a final tax in the hands of the investor. The Belgian tax authorities apply this 15% rate to dividends distributed by a foreign UCITS in Belgium only when the UCITS is an investment company that is publicly marketed in Belgium. Although this is not stated in the tax law, the tax authorities have adopted this position in practice. If the UCITS is not publicly marketed in Belgium (as

is the case with most foreign UCITS sold to Belgian investors), the Belgian individual investors and pension funds will suffer income tax at 25% on this income. Therefore, in practice, a tax rate of 25% is generally levied when foreign UCITS make such a distribution to Belgian investors.

The existing law would appear to discriminate against certain foreign UCITS. For these UCITS, the disadvantages arise entirely because of the Belgian tax system. It is feasible that this discrimination could be successfully challenged in the European Court by the promoter of a UCITS disadvantaged in this way, or by an individual investor into the UCITS.

- **Participation exemption**

  Introduced in 1992.

  As far as Belgian corporate investors are concerned, the Belgian income tax code provides a look-through rule for the application of the participation exemption regime[19] to dividends distributed by SICAVs. In order to apply this look-through rule, domestic and foreign SICAVs must comply with very strict conditions laid down in the Belgian Income Tax Code, one of which is that they must be subject to tax in their jurisdiction. The exemption, if granted, will make the dividend distribution tax exempt in the hands of the Belgian corporate investor. Belgian SICAVs, although they are subject to tax, have a taxable basis which is determined in a way that it is generally zero (or in any case very low).

  Distributions by a Belgian SICAV to a Belgian corporate, therefore, will generally qualify for this tax exemption.

  However, dividends distributed by foreign SICAVs which are not subject to tax in their jurisdiction (e.g. a Luxembourg SICAV), are excluded from the benefit of the above exemption.

  This is discriminatory against foreign UCITS as distributions received by a Belgian corporate from investments in a non-Belgian UCITS as above will not gain the benefit of this tax exemption.

- **Benefit from foreign tax credits**

  According to the Belgian income tax law, Belgian corporate investors can benefit from foreign tax credits as provided by the Belgian internal law (thus not under double tax treaties). The tax credit corresponds to a fixed proportion of the foreign withholding taxes applied on the interest received by a SICAV. Thus for a corporate investor a kind of transparency rule applies to permit these foreign tax credits to flow through to the investor, which reduces the corporation tax bill.

  However this look-through rule only applies to corporate investors investing in Belgian SICAVs. In case of an investment in foreign UCITS, foreign tax credits cannot be claimed by the corporate investors for the interest received by the foreign UCITS.

[19] The participation exemption regime provides for complete exemption from tax in relation to dividend distributions received and capital gains realised by Belgian corporate investors under certain circumstances as described above.

## Denmark

- **Foreign fund legislation**

  Introduced in 1986.

  Under Danish tax legislation if the foreign fund is taxed at an income rate below 22.5% in its own jurisdiction, which in practice all UCITS will be, Danish investors investing into the UCITS will be severely disadvantaged; any gain made by the investor will be taxable, calculated as proceeds less cost (with an additional 10% uplift on any resulting gain made) with no loss relief available. Danish investors investing into Danish UCITS will face a less onerous tax liability on any gain made (in some cases gains made will be exempt from tax); the exact tax liability arising will vary depending on the nature of the Danish UCITS and its investments.

  The legislation overrules the ordinary rules. Under the interpretation adopted by the Danish tax authorities this means that it will apply even to a foreign fund that invests in high taxed assets such as Danish shares.

  As a result of this legislation very few fund promoters have been able to sell foreign UCITS into Denmark and currently only around six UCITS are registered for sale there. Many pan-European promoters (for example, Fidelity) are active in the other Scandinavian countries and cite the existing tax rules in Denmark as being a key reason why they do not do business in Denmark.

  This legislation represents a clear discriminatory pressure against foreign UCITS. It is possible that this discrimination could be successfully challenged in the European Court by the promoter of a UCITS disadvantaged in this way, or by an individual investor into the UCITS.

## France

- **Plan d'Epargne en Actions ("PEA")**

  Introduced in 1992.

  French investors may benefit from certain reliefs from French taxation by investing in a PEA provided the investment is made in predominantly French equities, or by a French UCITS such as an FCP or SICAV invested into French equities. An investor in a foreign UCITS that invests into French equities will not qualify for the same tax reliefs.

  On this basis the structure of this relief discriminates against foreign UCITS.

- **Franchise relief**

  Introduced in 1965.

  French individuals can benefit from a franchise relief amounting to 8,000 FF (16,000 FF for a couple) on dividends paid by French companies (including French SICAVs and French FCPs if the latter pays a coupon made up of dividends of French companies).

  This benefit does not extend to income paid by non-French European companies (such as a foreign UCITS) and is thus discriminatory against foreign UCITS.

- **French imputation tax system**

The French tax system operates what is known as an imputation system, similar in operation to the UK system discussed in detail below. The key part of the French system to note here is that when a French UCITS makes a distribution to French investors, the French UCITS can transfer tax credits, attached to its source income, to the investor. For example, a tax credit (“avoir fiscal”) is attached to French dividends received at a rate of 50% for individuals and 25% (reduced to 15% from 2002 onwards) for corporations. Tax credits equal to the treaty rate in the case of foreign source income received up to 50%/40% of the dividend paid by a French SICAV are also available to the French investor. These tax credits can be transferred to the investor, thus reducing his tax liability.

By contrast, France does not recognise the “transparency” of foreign UCITS and therefore dividends received by a French investor from a non-French UCITS will not be imputed with tax credits as discussed above, as the distribution from the non-French UCITS would be regarded as a receipt of overseas income (even if the underlying income is French dividend income). For the French investor who wishes to hold a UCITS investment into French equities this creates a clear discrimination in favour of the French UCITS as against the foreign UCITS.

The existing law would appear to discriminate against foreign UCITS. For these UCITS, the disadvantages arise entirely because of the French tax system. It is feasible that this discrimination could be successfully challenged in the European Court by the promoter of a UCITS disadvantaged in this way, or by an individual investor into the UCITS.

## Germany

- **Existing foreign investment fund law**

Originally introduced around 1969 with subsequent amendments.

Under existing foreign funds law in Germany, fund sponsors either appoint a German paying agent or can opt to be a category 2 or 3 fund. Investors in Category 2 or 3 funds will be taxed on undistributed income and capital gains, giving rise to a higher level of taxation than investment in an equivalent German UCITS. These measures are further extended where a fund fails to appoint a German tax representative. In this case the investor must pay tax on distributions and also on 90% of the increase in the redemption price of his units or shares during the calendar year (where an increase does not exist: at least 10% of the last redemption price of the last year). 20% of the sales price is also subject to tax in case of selling the fund shares. This significantly disadvantages investors in foreign funds in comparison to domestic funds.

The existing law would therefore appear to discriminate against German investors in Category 2 or 3 funds and this discrimination arises as a result of the actions of the fund’s promoter. As such, it should be capable of being challenged under the EU Treaty.

- **New tax reform measures**

With effect from 1 January 2001.

The German government has recently introduced new tax reform proposals that have reduced the tax on investments held in domestic funds in comparison to those held in foreign funds. It should be noted that FEFSI have already made representations to the German government and European Commission (in Autumn 2000) pointing out that these new rules represent an unacceptable discrimination against foreign UCITS.

A major part of the German tax reforms, which became law on 1 January 2001, is the removal of the current tax credit system intended to remove double German taxation of profits within a company and also in the hands of the company's shareholders. Under the new system, only 50% of the dividend income will be treated as taxable income for individual investors and dividends will be tax free for corporate investors (for private partnerships only 50% will be tax free).

To prevent direct investment becoming significantly preferable to investment through a German fund vehicle as a side effect of this change, individuals will also only be taxed on 50% of income received from German domestic funds in respect of both German and foreign dividend income received into the fund.

By contrast investors who receive similar dividends from foreign funds will be taxed at their full tax rate on their income.

Under the previous system, all capital gains realised by corporate entities were subject to tax. This will be abolished under the new rules, and instead capital gains on shares made by German funds on the disposal of investments, and capital gains on shares made on the disposal of fund units, will be tax free or 50% tax free for corporate investors. However capital gains made by foreign funds will be treated as taxable income of German corporate investors (if these gains are distributed). In addition German corporate investors will still be subject to tax on capital gains made on the disposal of foreign fund holdings.

As can be seen from these examples, both corporate and individual investors will be disadvantaged by an investment in a foreign rather than German fund regardless of whether this fund invests in German or foreign securities.

For investors who invest in foreign funds that receive non-German dividend income, the disadvantages arise entirely because of the new German tax system, which allows a significant proportion of income from German funds to remain tax-exempt for German investors. This discrimination could feasibly be successfully challenged in the ECJ by either a corporate or an individual investor.

The examples below set out the comparative position for investment in German UCITS versus foreign UCITS:

| German Equity Fund | Sondervermögen | UK OEIC UCITS (registered under §17 in Germany) |
|---|---|---|
| German dividend income | 1,000 | 1,000 |
| Interest income | 200 | 200 |
| Capital gains from investments | 20,000 | 20,000 |
| Expenses | (900) | (900) |
| | 20,300 | 20,300 |
| Tax in fund | (0) | (150) |
| Total return | 20,300 | 20,150 |
| **Tax on income** | | |
| **German individual investor** | | |
| Income return to investors | 300 | 150 |
| Taxable return | 175[20] | 150 |
| Tax paid (45%) | **79** | **68** |
| Net income after all tax | 221 | 82 |
| **German corporate investor** | | |
| Deemed income return | 300 | 150 |
| Taxable return | 50 | 150 |
| Tax at 25% | **12.5** | **37.5** |
| Net income after all tax | 287.5 | 112.5 |

For the German individual investor in the German fund the lower tax burden than in the UK OEIC flows from two factors. First 50% of the dividend receipts from the fund are not taxable and second German withholding tax can be offset against the final tax liability. However in the case of the UK OEIC, German withholding tax is not allowed to flow through to the investor as a credit against German tax leading in effect to double taxation.

For corporate investors the dividend element is tax free from the German fund but taxable from the UK OEIC. In addition the UK OEIC suffers German withholding tax which cannot be credited to German investors.

20 This is calculated on a look through basis:

| | Total income | Interest | Taxable Dividends* | Dividends |
|---|---|---|---|---|
| Income | 1,200 | 200 | 500 | 500 |
| Expenses | (900) | (150) | (375) | (375) |
| | 300 | 50 | 125 | 125 |
| Taxable income | **175** | **50** | **125** | |

*being 50% of dividend

**Tax on gain**

(Assumes that the investor sells holding after one year, one day)

| | Sondervermögen | UK OEIC UCITS (registered under §17 in Germany) |
|---|---|---|
| **German individual investor** | | |
| Net capital gain on disposal retained after tax[21] | 20,000 | 20,000 |
| **German corporate investor** | | |
| Net capital gain on disposal before tax | 20,000 | 20,000 |
| Tax at 25% | 0[22] | 5,000 |
| Net gain retained after tax | 20,000 | 15,000 |

As can be seen from the above, German corporate investors are severely disadvantaged by investing in a foreign UCITS because capital gains tax is levied on the gain arising from the sale of the non German UCITS , but not from the equivalent German UCITS or Sondervermögen.

21 No tax as the individual has held the shares for longer than 1 year

22 Capital gain on holding in domestic fund exempt from tax while gain in foreign fund remains taxable

| Non-German Equity Fund | Sondervermögen | UK OEIC UCITS (registered under §17 in Germany) |
|---|---|---|
| Spanish dividend income | 1,000 | 1,000 |
| Interest income | 200 | 200 |
| Capital gains from investments | 20,000 | 20,000 |
| Expenses | (900) | (900) |
| | 20,300 | 20,300 |
| Tax in fund (WHT on dividend income) | (100) | (100) |
| Total returns | 20,200 | 20,200 |
| **German individual investor** | | |
| Income return to investors | 200 | 200 |
| Taxable return | 175[23] | 200 |
| Tax paid (45%) | **22.5**[24] | **90** |
| Net income | 177.5 | 110 |
| **German corporate investor** | | |
| Total income return | 200 | 200 |
| Taxable return | 50 | 200 |
| Tax at 25% | **12.5** | **50** |
| Net income | 187.5 | 150 |

In the above example only half the dividend income into the German fund is taxable for individual investors whereas the full dividend is taxable when received from the UK OEIC. In addition the investor in the German fund receives credit for the Spanish withholding tax suffered but no such credit is allowed for investment through the UK OEIC.

23

| | Total income | Interest | Taxable dividends* | Tax free dividends |
|---|---|---|---|---|
| Income | 1,200 | 200 | 500 | 500 |
| Expenses | (900) | (150) | (375) | (375) |
| | 300 | 50 | 125 | 125 |
| **Taxable income** | **175** | **50** | **125** | |

*being 50% of the dividend

24 Relief for Foreign withholding tax suffered on dividend income is given against the final tax liability.

| | Total income | Interest | Dividends |
|---|---|---|---|
| Taxable income | 175 | 50 | 125 |
| Tax at 45% | 78.5 | 22.5 | 56 |
| Double tax relief | (56) | - | (56) |
| | **22.5** | **22.5** | **0** |

For corporate investors the dividend from the German fund is tax free but taxable from the UK fund which is illustrated below.

**Tax on gain**

(Assumes that the investor sells holding after one year, one day)

| | Sondervermögen | UK OEIC UCITS (registered under §17 in Germany) |
|---|---|---|
| **German individual investor** | | |
| Net capital gain on disposal retained after tax[25] | 20,000 | 20,000 |
| **German corporate investor** | | |
| Net capital gain on disposal before tax | 20,000 | 20,000 |
| Tax at 25% | 0[26] | 5,000 |
| Net gain retained after tax | 20,000 | 15,000 |

Clearly the imposition of capital gains tax in relation to gains made by corporates on sale of foreign UCITS gives rise to a major discrimination which should be open to challenge under the EU Treaty.

## Greece

- **Investment funds legislation which penalises foreign UCITS**

  Introduced 1991

  A Greek investment fund must withhold income tax on interest received by the fund. This is the only tax obligation of unitholders in respect of this income.

  Under Greek tax legislation, domestic investment funds are subject to a flat 0.3% (per annum) tax, computed on the half-yearly average of the fund's net assets. No further tax is payable by the Greek investor. Any capital gains on redemption of units are exempt from tax.

  However a different treatment applies to foreign funds. Income from foreign funds is subject to withholding tax of 20% and inclusion in total income taxed at the standard rate of income tax of up to 42.5% (2001). Any capital gains on redemption of units in foreign funds are also subject to final taxation of up to 42.5% (2001).

  In so far as the tax burden on investors in foreign funds under this regime is higher than for Greek domestic UCITS the existing income tax law would appear to discriminate against certain foreign UCITS, despite the opinion of the Greek Ministry of Economics that these taxes are lawful under the EC Treaty. For these UCITS, the disadvantages arise entirely because of the Greek tax system. It is

[25] No tax as the individual has held the shares for longer than 1 year

[26] Capital gain on holding in domestic fund exempt from tax while gain in foreign fund remains taxable

feasible that this discrimination could be successfully challenged in the European Court by the promoter of a UCITS disadvantaged in this way, or by an individual investor into the foreign UCITS.

## Ireland

- **Taxation of Irish investors in offshore UCITS**

Introduced in 2001

Changes introduced in the Irish Finance Act 2001 have eliminated much of the tax discrimination that previously arose between investments made by an Irish individual or corporate in an Irish UCITS as compared to an offshore UCITS. However, a 2% differential applies to corporate investors in a non-distributing offshore UCITS (see below).

An Irish individual receiving income from an Irish or offshore UCITS will be taxed on that income at 20%, and any capital gains made on disposal of units in an Irish or offshore UCITS will be taxed at 23%. This tax treatment will apply whether the offshore UCITS is a distributing fund or not.

Irish corporates will be charged tax at a rate of 25% on an income arising from an Irish or offshore UCITS, again irrespective of whether that offshore fund is distributing or not. Capital gains made on disposal of units in an Irish UCITS will be taxed at 23%. Capital gains made on disposal of units in a distributing offshore UCITS will also be taxed at a rate of 23%. However, gains arising on the disposal of units in a non-distributing offshore UCITS will be taxed at a rate of 25%, a 2% increase over a distributing fund.

Offshore UCITS will need to comply with strict reporting requirements for the above taxation regime to apply to the Irish investor. The reporting requirements are similar in effect to the strict tax declaration procedures applicable to Irish UCITS, the onshore product. Given this similarity between the requirements for Irish and offshore UCITS it would seem unlikely that the requirement to report could be regarded as a discrimination.

The 2% increase in tax charge for Irish corporates investing in non distributing funds would appear to be discriminatory and capable of challenge in the European Court of Justice if the Irish authorities do not remove it in the meantime.

## Italy

- **Capital gains tax**

Introduced in 1998.

The Italian government introduced a range of tax regulations that have an adverse tax impact for many non-resident UCITS investing in Italian companies. These regulations are complex, but a brief outline of the main impact for non-resident UCITS investors is highlighted below.

The regime impinges on non-resident UCITS which are not covered by an Italian double tax treaty (for example a Luxembourg SICAV) and which own, at any time, in excess of 2% of the voting rights or 5% of the capital of shares in an Italian company that is quoted on a recognised stock exchange. Any gains made by such UCITS on the disposal of such holdings will be subject to tax in Italy at the rate of 27%

if the disposals made in a 12 month period exceed the thresholds above. Any proceeds collected by individual Italian investors upon disposal of the units or periodical distribution are subject to taxation at a rate of 12.5%. Therefore double taxation may occur on the same income i.e. on the capital gains realised on the disposal of the shareholdings.

By contrast any gains made on the disposal of Italian quoted stocks by non-resident UCITS with treaty access, or UCITS with no treaty access with holdings below the thresholds outlined above, will suffer no tax in Italy. Also Italian UCITS making disposals of Italian quoted stocks will suffer tax at a rate of only 12.5% on gains made. Any proceeds received by the Italian investors by way of disposal or distribution will not be taxed in the hands of the investor.

The existing law would appear to discriminate against non-resident UCITS not covered by a treaty. For these UCITS, the disadvantages arise entirely because of the Italian tax system. It is feasible that this discrimination could be successfully challenged in the European Court by the promoter of a UCITS disadvantaged in this way, or by an individual investor into the UCITS.

## Netherlands

- **Reclaim of foreign withholding taxes**

Laws originally introduced in 1970.

As a Dutch investment fund does not have corporate income tax liability, it cannot claim a credit for foreign withholding taxes incurred on foreign-source dividends and interest. By contrast, a Dutch individual investing directly in foreign shares or debt instruments can ordinarily claim a credit for foreign withholding taxes. In order to achieve neutrality between direct investment by a Dutch individual and investment through a Dutch investment fund the Dutch investment fund can obtain a reimbursement from the Dutch tax authorities for foreign withholding taxes. This reimbursement is calculated in proportion to the number of Dutch investors in the Dutch investment fund who are subject to tax and would have been able to claim a credit based on a tax treaty or unilateral provisions had they received the income directly. This reimbursement is paid to the Dutch investment fund and needs to be included in the income that will be distributed to all the investors in the Dutch investment fund. This is not affected by the recent tax reform in the Netherlands, discussed on page 31.

The above mentioned refund procedure does not apply to Dutch investors investing directly into a foreign UCITS. Therefore, Dutch individual investors, tax paying institutions and to some extent tax exempt institutional investors will be encouraged to invest in a Dutch UCITS, thus discriminating against the foreign UCITS.

## Portugal

- **Different income tax regimes for individual investors**

Laws originally introduced in 1989, amended in 2001

Under new tax reform laws introduced in 2001 many of the previously discriminatory tax measures against foreign UCITS sold into Portugal have been removed or significantly reduced.

However any investor in a foreign UCITS with no Portuguese paying or collecting agent who redeems units or shares will typically be taxed at the highest marginal rate (currently 40%) and not subject to the flat rate withholding tax of 20% applicable to holdings in domestic UCITS or foreign UCITS that have a domestic Portuguese paying or collecting agent.

It could be argued that this regime remains discriminatory. This is because investors who invest in a foreign UCITS that does not have a local paying or collecting agent will be penalised by being subjected to a higher level of taxation than for a similar investment in a domestic UCITS. In the Safir case (see Appendix A) the creation of administrative obstacles to the purchase of a foreign insurance product coupled with an adverse tax treatment was held to amount to an unacceptable discrimination. In the Portuguese case the legislation requires a Portuguese paying or collecting agent to avoid tax discrimination. The possible outcome of a case is perhaps rather less clear than for other discriminations raised in this report because the Portuguese government may be able to argue that local paying agents or collecting agents are required to ensure fiscal cohesion in their taxation system.

## United Kingdom

- **The UK offshore fund legislation.**

  Introduced in 1984.

  This legislation was originally introduced to restrict the possibility for UK residents to accumulate income within offshore investments, thereby turning income into capital gains. It was and continues to be the case that in the UK capital gains are taxed more favourably than income returns. Onshore investment funds in the UK are required to distribute their income each year to investors who are then taxed. Without the offshore fund legislation therefore it was clear that the UK fund industry would have been at a disadvantage and that the income tax base was also at risk.

  The method chosen by the UK government to redress the balance was to introduce legislation known as the offshore fund legislation which requires promoters of UCITS to apply to the Inland Revenue annually to obtain certification that the fund has met certain conditions.

  Among these conditions is a requirement that the offshore fund must distribute 85% of its income, thus producing a broadly equivalent result for the investor, to an investment in an onshore UK UCITS.

  It should be noted that this legislation places the onus on the promoter to obtain the distributor status.

  It is this requirement that is likely to be regarded as unacceptably discriminatory. For example, it would be entirely possible for a UK person to invest in a UCITS and to suffer a tax disadvantage simply because the promoter did not obtain the necessary certification. Moreover the timetable for obtaining such certification is very tight.

  Within the legislation there are some procedures for individual investors to themselves obtain certification but this is likely to be onerous given that the investor may not have full access to information about the fund. It is also likely to be the case that an investor in a fund that failed to obtain certification as a distributing fund, say because it only distributed 80% of its income, would also have grounds to claim that the UK tax law is discriminatory by virtue of subjecting them, through no fault of their own, to higher levels of tax than would be the case if they were taxed under the UK capital gains regime.

Perhaps even more discriminatory would be the case of an investor in a foreign fund with no income after management expenses. If the promoters of such a fund did not obtain certification then it is most likely that the UK investors would be subject to income tax on the capital gains when the shares/units are sold. This is clearly a discrimination (when compared to the position for an identical UK fund) which the investor could only avoid by seeking certification individually, which is likely to be both onerous and difficult because full information would not be available.

On the surface, the certification procedure is not particularly onerous for fund promoters. However the current interpretation is that an umbrella fund, that is a UCITS with a number of sub-funds, must obtain distributor status in respect of every sub-fund to be certified even though it may be the case that UK investors are allowed to invest into only a small number or even one of the sub-funds.

The alternative for the UK government to achieve their policy aim of a level playing field would be to amend the legislation so as to tax investors in non-UK UCITS on their share of any income arising in the UCITS regardless of whether a distribution had been made.

- **UK imputation tax system**

Introduced around 1971 with amendments in the Finance Act 1998.

The UK tax system operates what is known as an imputation system. The reference to imputation relates to the principle that some of the corporate tax paid in relation to corporate profits should, when dividends are paid on to shareholders, be imputed to the shareholder so that the same income is not in effect taxed twice (i.e., once in the company and once on the investor).

A key part of this system is that dividends received by a UK UCITS from a UK company are exempt from taxation. Then, as the UK UCITS makes a distribution to UK investors those investors receive the income with an imputed tax credit as though they had invested directly in the wider underlying corporate. The credit will then be used to reduce their tax liability.

By contrast dividends received from overseas companies are subject to tax in full without a similar exemption as for UK dividends. Thus a UK OEIC will be taxed on foreign income dividends received but not on UK dividend income received. This often results in a direct financial cost to the investor which will tend to have the effect of favouring UK equity investments as against equity investments in other EU companies. This would seem to have many parallels with the Verkooijen case summarised in Appendix A. (However it should be noted that funds may offset management costs, thereby resulting in a very low or nil corporate tax bill in many cases so that for some equity funds the financial effect of this discriminatory system can be quite limited).

The example below shows how net receipts from UK funds invested primarily in overseas equities are lower than receipts from UK funds invested in UK equities.

## UK OEIC: UK dividend income vs foreign dividend income: Example of how the UK tax system delivers different returns

| | **UK OEIC with UK dividend income** | **UK OEIC with overseas dividend income** |
|---|---|---|
| UK Dividend received | 100 | |
| Foreign (e.g. German) dividend received (incl. wht) | | 100 |
| UKCorporation Tax in fund | (0) | (5) |
| Withholding Tax | (nil) | (15) |
| Distributed returns | **100** | **80** |
| **UK Individual investor:** | | |
| Income received (A) | **100** | **80** |
| Tax credit thereon | 10 | 8.9 |
| Taxable income | 110 | 88.9 |
| Tax liability (assume higher rate taxpayer) | 35.75 | 28.9 |
| Less: tax credit | (10) | (8.9) |
| Tax paid (B) | 25.75 | 20.5 |
| Net income (A-B) | **74.25** | **59.5** |
| **UK Corporate investor:** | | |
| Income received | 100 | 80 |
| Tax liability | (nil) | |
| Net income | **100** | **80** |

## UK imputation system: Further discriminatory aspects

As noted below, UK investors receive UK dividend income with an imputed 10% tax credit which can be used to reduce their income tax liability. If their investment is routed through a non-UK UCITS, the entitlement to the tax credit is lost because they will be taxed on the distribution from the UCITS, which will be treated as overseas dividend income in their hands.

This means that investment in a non-UK UCITS is less advantageous for a UK investor than investing directly in UK equities, or investing in them via a UK fund. This generates a discrimination in favour of UK equity funds compared to foreign funds with the same investment profile.

The adverse impact on investors from these provisions are shown by way of the example below:

UK dividend income: UK UCITS vs Foreign UCITS: Example of how the system delivers different returns in relation to UK dividend income.

| | UK UCITS (e.g. UK OEIC) | Foreign UCITS (e.g Luxembourg SICAV) |
|---|---|---|
| UK Dividend received | 100 | 100 |
| Tax in fund (incl. wht suffered) | (nil) | (nil) |
| Distributed returns | **100** | **100** |
| **UK Individual investor:** | | |
| Income received (A) | 100 | 100 |
| Tax credit thereon | 10 | - |
| Taxable income | 110 | 100 |
| Tax liability (assume higher rate taxpayer) | 35.75 | 32.50 |
| Less: tax credit | (10) | |
| Tax paid (B) | 25.75 | 32.50 |
| Net income (A-B) | **74.25** | **67.50** |
| **UK Corporate investor:** | | |
| Income received | 100 | 100 |
| Tax liability (incl wht) | (nil) | (30) |
| Net income | **100** | **70** |

## Some recent progress in reversing discrimination…

Although progress in removing some of the barriers above has been slow, there have been a few instances where Member States have been persuaded to remove discriminatory tax measures.

## Germany

Further to FEFSI's concerted action, the German Ministry of Finance recently revealed in the Federal Government's Report to the Finance Committee (of the Bundestag) that an amendment of the new tax reform measures will be required as part of the on-going company taxation reform efforts. The amendment of the "Auslandinvestments-Gesetz" will presumably consist of placing so-called "white-listed" foreign funds on the same footing as domestic investment funds in terms of tax treatment. "White-listed" investment funds will be those foreign funds that have been registered for marketing in Germany or whose units/shares are listed on a German stock exchange. "Grey-" or "black-listed" funds are not to benefit from such treatment.

## Netherlands

Previously investments of Dutch individuals in foreign UCITS (and other Funds) were taxed on a deemed income basis (investments were deemed to generate a certain income), as opposed to investments in local funds which were taxed on a real income basis. Through use of a counterproof facility ("counterproof procedure") investors in foreign funds could achieve similar tax treatment to investors in local funds.

However, the counterproof procedure itself may have been considered an additional (discriminatory) tax burden.

As of 1 January 2001 all investments/assets (foreign and local) of Dutch individuals are taxed on a deemed income basis. The deemed return is 4%, which is taxed at a rate of 30%.

Thus discrimination against investments in foreign funds has therefore been removed.

## Portugal

Under new tax reform laws introduced in 2001 many of the previously discriminatory tax measures against foreign UCITS sold into Portugal have been removed or significantly reduced.

## Spain

Spain has tax measures that discriminate against funds considered to be based in 'tax havens'. Spain no longer has provisions against UCITS in Luxembourg, previously considered to qualify for these tax measures by the Spanish authorities, although other non UCITS tax haven funds are still within the legislation.

# Appendix A

## Case analyses

### Staatssecretaris van Financien v BGM Verkooijen (C-35/98) ("Verkooijen")

The case involved a Dutch national, Mr Verkooijen, who worked for a subsidiary of a Belgian oil company, Petrofina NV, and who received shares in that company under an employee share savings scheme. Mr Verkooijen claimed an exemption for the first NLG 2,000 of Belgian dividend income that he received, on the basis that he would have been entitled to an equivalent relief had he held shares in a Dutch rather than a Belgian company.

The Dutch tax authorities challenged Mr Verkooijen's claim and the case was initially heard before the Dutch tax court which ruled in the taxpayer's favour on the basis that the freedom of establishment and freedom of movement of capital provisions of the Treaty had been infringed. The case was then appealed by the Dutch tax authorities to the Dutch Supreme Court which referred the case to the European Court of Justice for clarification as to whether the discrimination represented an illegal infringement of the Treaty or was permitted under the Bachmann principle. The Court held in favour of Verkooijen on the grounds that the case infringed the free movement of capital. However, having established that one fundamental freedom had already been contravened, the Court did not proceed further, since it was unnecessary to consider whether freedom of establishment had similarly been infringed. Thus, the judgment is not as complete as it could be.

In reaching its decision, the Court had regard to the circumstances under which the exemption for domestic Dutch dividend income had arisen. This arose wholly as a consequence of the desire of the Dutch authorities to encourage private individuals to invest in the shares of Dutch companies.

As the Netherlands operates a "classical" system of taxation under which none of the tax suffered by the paying company is "imputed" against the income tax liability of a private individual, an investment in a Dutch company would have led to double taxation. Accordingly, in express recognition of the double taxation that would arise, an exemption was established for the first NLG 2,000 of domestic dividend income received. No corresponding relief, however, was afforded to overseas dividend income. The Dutch authorities firstly claimed that they were permitted to discriminate against investments in overseas companies on the basis that article 73d(1)(a) (now article 58(1)(a)) of the Treaty permits Member States to distinguish between taxpayers (whether by place of residence or the place where their capital is invested) so long as the discriminatory provisions existed prior to the enactment of the Final Act of the Treaty. The Court, however, disagreed with this interpretation, holding that the "national [legal] provisions" to which article 73d(1)(a) applies are to be interpreted by reference to article 73d(3) which requires that they do not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital.

The Court then went on to consider the other arguments advanced in justification of tax discrimination.

These comprised:

- the promotion of the economy of the country by encouraging individuals to invest in domestic companies;
- prevention of the erosion of the Dutch tax base that would otherwise occur if individuals were granted exemption for overseas dividend income;
- preservation of cohesion of the Netherlands tax system.

The first two arguments were dismissed by the Court on the basis that "reduction in such tax revenue cannot be regarded as an overriding reason in the public interest which may be relied upon to justify a measure which is in principle contrary to a fundamental freedom".

As regards the fiscal cohesion defence, the Court observed that for this defence to succeed a direct link must exist for one taxpayer "standing alone" between the granting of a tax advantage and the offsetting of that

advantage by a fiscal levy. In the case of Bachmann, the grant of [Belgian] income tax relief for life assurance payments had been offset by the corresponding taxation of the sums arising on maturity. Because Bachmann ('B') wanted to use a non-Belgian insurance company there would be no guarantee that tax relief for investments by 'B' would be offset later by tax levied on 'B' on those investments at maturity. Therefore the fiscal cohesion of the tax system was at risk if individual taxpayers could avoid tax in this way.

In Verkooijen's case, however, no such direct link existed as two separate taxes (Dutch income tax and Belgian corporate tax) were involved, which were levied on separate taxpayers (Verkooijen himself and Petrofina NV).

The European Court's decision in Verkooijen has provided much needed clarity on the limits of the fiscal cohesion defence as well as affirming the earlier decision in ICI v Colmer, and in turn Commission v France, that a reduction in tax revenue cannot be regarded as an overriding reason to justify discrimination. Whilst the Court was careful to preface this latter remark with the caveat that it applied only to "natural persons" subject to income tax, the ramifications of the case are potentially far wider.

The case opens the door to further litigation, as discussed in this report under the UK imputation system section, for example in relation to double tax relief for overseas dividend income. The outcome of any such litigation may also have profound implications for the permissibility of imputation systems within the EU as the latter may function by discriminating against dividends from overseas companies. One possible interpretation of this case is that imputation systems that impute a tax credit to an individual only on dividends from domestic companies are not permissible under the Treaty.

This would be a truly seismic conclusion for countries such as the UK with such systems because some fundamental pillars of the domestic tax system would have to be redesigned.

### Safir v Skattemyndigheten i Dalarnas Lan – CJEC C-118/96 ("Safir")

Safir took out a life insurance savings policy with a British insurance company and sought exemption from payment of Premium Tax which under the terms of Swedish law was a special levy on Swedish individuals who took out a policy with a non-Swedish insurance company. The levy or tax could be reduced if Mrs Safir could show that the foreign (non Swedish) insurance company had suffered tax at a similar level to a Swedish insurance company. There was also a sliding scale so that for example if the foreign insurance company were taxed at half the rate of an equivalent Swedish insurance company the levy/tax suffered by Mrs Safir was reduced commensurately. The rationale for the system was to stop Swedish individuals being attracted to foreign insurance/savings policies that were more attractive simply because the foreign insurance company suffered less tax than the equivalent Swedish insurance company. In the event Mrs Safir suffered a levy/tax on her premiums and she appealed this case.

The Swedish government argued that such a tax filled the vacuum caused by the failure to tax savings in the form of life insurance held offshore. This argument was rejected on the basis that a more transparent system, which did not discriminate against insurance companies incorporated in another Member State, would be possible.

The European Court held that national legislation that discriminated between resident and non-resident companies was precluded by Article 59 (now Article 49) of the Treaty relating to the freedom to supply services (in this case insurance services) throughout the EU. Consequently, the main conclusion that can be derived from Safir was that barriers raised against those wishing to obtain insurance services in Sweden from a foreign provider were not permissible under the freedom to supply services Article of the Treaty.

One tax regime that has a number of parallels with the above is the offshore funds legislation in the UK (similarly the foreign funds legislation in Ireland and certain other EU jurisdictions). Arguably the differing treatment offered to onshore and offshore funds in the UK may discourage certain UK residents from investing in offshore vehicles. The possible reasons why the UK offshore funds legislation is considered discriminatory are explored in depth in this report.

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