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AG Opinion in Emerging Markets Series of DFA Investment Trust Company case

Poland – free movement of capital – third country shareholdings

On November 6, 2013, Advocate General (AG) Paolo Mengozzi of the Court of Justice of the European Union (CJEU) released his opinion (which is not yet available in English) in the Emerging Markets Series of DFA Investment Trust Company case (C-190/12).

AG Mengozzi concludes that a different tax treatment for dividend payments made to third country rather than domestic investment funds constitutes a restriction on the free movement of capital. However, the restriction can be justified based on the need to ensure the effectiveness of fiscal supervision.

The key factor in his reaching the above conclusion was the absence of a framework that allows for the exchange of information on the foreign investment fund's regulatory position, equivalent to the EU's UCITS Directive (85/611/EEC). According to the AG, this means that the relevant domestic authorities cannot verify that the foreign investment fund carries out its activities under conditions comparable to those provided under Polish law for investment funds.

Background

The case is a referral from the Polish Administrative Court. In dispute is whether the different tax treatment provided under Polish law for dividends paid to resident and non-resident investment funds is compatible with the free movement of capital.

Polish corporate income tax (CIT) law as amended in 1997, exempts domestic dividends paid to investment funds operating on the basis of Polish law on investment funds. In 2011, as a consequence of an infringement procedure initiated by the Commission, a similar exemption was also extended to dividend payments made to EU Member State investment funds meeting certain conditions specified by the Polish CIT Act. Conversely, outbound dividends paid to a third country investment fund are subject to a 19 percent final withholding tax (subject to a potential double tax treaty reduction).

The AG's opinion

AG Mengozzi extends the rationale set forth in the Test Claimants in the FII Group Litigation case (C-35/11) regarding inbound dividends from third countries, to outbound dividends (i.e., dividends paid by an EU resident entity to a third country shareholder). This means that where, as in the case at hand, the different tax treatment of EU domestic and outbound dividends does not depend on the size of the

shareholding in the company making the dividend distribution, this can, in principle, be challenged as being incompatible with either the free movement of capital or the freedom of establishment.

Furthermore, if the difference in treatment of domestic dividends and outbound dividends has the effect of discouraging third countries from investing in Poland, while discouraging resident investors from investing in non-resident investment funds, this will, in principle, amount to a restriction of the free movement of capital, which is prohibited by Article 63 TFEU.

Although a different tax treatment can be accepted if it concerns situations that are not objectively comparable, AG Mengozzi argues that, based on the Santander Asset Management SGIIC case (C-338/11), the situation of a non-resident investment fund is comparable to that of a resident investment fund, since the distinguishing criterion for determining the applicable tax treatment is not the regulatory requirements for the investment fund's incorporation and functioning, but rather whether or not it is resident in Poland.

Given that the domestic dividend exemption was introduced in 1997, AG Mengozzi points out that the provision in question is not protected by the 'standstill clause', which does not prohibit a restriction on third country capital movement in cases of direct investments if the relevant measure was already in place on December 31, 1993.

The AG went on to conclude that the Polish rules constituted a restriction on the free movement of capital, but were justified on the grounds of overriding reasons relating to the public interest, in particular the need to ensure the effectiveness of fiscal supervision.

According to AG Mengozzi, the absence of a framework for the exchange of information on regulatory matters, equivalent to the EU UCITS Directive (85/611/EEC), justifies a restriction on third country capital movements in the case at hand. However, he also argues that it is irrelevant whether or not there are provisions in place for the exchange of information on tax matters, since these would not help the Polish authorities verify whether a third country investment fund carries out its activities under conditions comparable to those provided under Polish law on investment funds.

EU Tax Centre Comment

The key question in this case is whether the Polish tax authorities can verify information regarding the regulatory conditions applicable to a third country investment fund in order to ascertain its comparability with domestic funds. AG Mengozzi concludes that this would only be possible on the basis of arrangements for exchanging regulatory information, such as the provisions in the UCITS Directive, rather than tax information. If the Court follows the AG, this could mean that all third country claims will fail.

However, the AG's opinion is not binding on the CJEU and there are good arguments for assuming that the Court will not follow his opinion. Even if the Court applies the AG's reasoning, it would still be necessary to examine, on a case-by-case basis, what formal exchange of information powers exist between a source state and a claiming state, and whether or not the information to be exchanged is sufficient to demonstrate comparability with an exempt domestic fund.

Should you require further assistance in this matter, please contact the EU Tax Centre or, as appropriate, your local KPMG tax advisor.

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