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Danish differential tax rules for mutual investment funds in conflict with EU law

On 21 June 2018, the Court of Justice of the European Union (CJEU) delivered its ruling in the case of Fidelity Funds against the Danish Ministry of Taxation, C-480/16, regarding the taxation at source on dividends applicable to foreign mutual investment funds while comparable national investment funds are exempt from taxation at this level.

About the legal background of the case
The case concerns the free movement of capital (article 63) and the freedom to provide services (article 56) – although the latter is merely considered secondary to the former – against the Danish rules on the taxation of certain mutual investment funds which state that national funds may be exempt from taxation while this is not the case for foreign investment funds.

The general rule under Danish tax law is that resident companies are unlimited tax liable to Denmark and that non-resident companies are liable to tax on income from Denmark; among other things on dividends received from companies situated in Denmark. The dividend is generally subject to a withholding tax at a rate of 27%. However, according to the Danish Withholding Tax Act, certain exceptions may be adopted regarding investment funds that distribute a minimum amount to its members, or at least establishes a minimum amount to be taxed in the hands of its members though not necessarily distributing this amount.

In a ministerial order, pertaining to the Danish Tax Assessment Act, investment funds fulfilling the above-mentioned distribution requirement and being Danish residents have been exempted from tax at source on dividends received from Danish companies.

Facts of the case
On the backdrop that one of the requirements for being exempt from tax at source is inherently difficult, or rather impossible, for foreign funds to fulfil, *i.e.* tax residence in Denmark, Fidelity Funds and a great many other investment funds have filed claims under EU law claiming that the precondition constitutes a difference in the tax treatment based on the State of residence of the fund.

The difference in treatment, it is argued, amounts to a breach of the free movement of capital and the freedom to provide services as the conditions for non-residents funds carrying out investments in Denmark are less favourable than is the 21

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case for Danish tax resident funds. Furthermore, Fidelity Funds claim that this difference in treatment cannot be justified by reasons of public order, balanced allocation of powers of taxation or a need to safeguard the coherence of the tax system.

The ruling of the CJEU

Firstly, the CJEU considered whether the situation impaired both the free movement of capital as well as the freedom to provide services. The CJEU found that the restriction of the freedom to provide services was merely a result of the fact that the Danish rules constitute a restriction on the free movement of capital as the difference in treatment was manifested in different taxation of dividends. As such, the CJEU found that the alleged less favourable position of non-Danish funds when providing services was therefore not an independent issue.

The CJEU noted – which was not a point of dispute in the case either – that foreign and resident funds were treated differently in such a manner that it constituted an unfavourable position for foreign investment funds. As this may be permissible under EU law, the situation of resident and non-resident investment funds should be objectively comparable, as the difference in treatment would not otherwise constitute a breach of EU law. The CJEU found that the situations were indeed objectively comparable as Denmark imposes taxes on both resident and non-resident funds. Accordingly, the situation of the fund members did not change the comparability of the situations as Danish investors were taxed irrespective of whether they invested in resident or non-resident funds.

As the situations were comparable, Danish law had to be considered *vis-à-vis* the conditions for justified different treatment under EU law. This required the difference in treatment to either achieve balanced allocation of powers of taxation or a means to safeguard the coherence of the tax system.

The CJEU dismissed the argument that the difference in taxation was based on the balanced allocation of powers of taxation. On the basis of settled case-law, the CJEU stated that where a Member State has chosen not to tax resident investment funds in receipt of nationally-sourced dividends, it cannot rely on the argument that there is a need to ensure balanced allocation between the Member States when applying such tax on non-residents. The fact that Denmark does not hold jurisdiction to tax the non-resident funds on their income did not change this.

Regarding the need to safeguard the coherence of the tax system, a number of Member State governments had argued, that a restriction could be permissible if the benefit granted the resident funds was compensated directly by the obligation of the funds to withhold tax *vis-à-vis* their investors. CJEU noted that such a direct link could indeed make the restriction permissible. However, the CJEU found that the strict distinction between foreign and resident companies was not necessary in order to remedy the potential tax loss. Under the full cooperation of the investment funds, a less restrictive measure – which could accomplish the same in regard to safeguard a coherent tax system – would be to let the non-resident funds be taxed similar to Danish funds when meeting the same conditions.

Considering this alternative, the difference in treatment based on residence was found to be more restrictive than necessary and, therefore, in conflict with EU law.

Bech-Bruun's comments

The ruling of the CJEU is a welcome development for non-resident mutual investment funds making or looking to make investments in Denmark. It constitutes a significant step towards the Danish courts acknowledging the many claims being filed for the reclaim of dividend tax. Also, a ruling will require an amendment to Danish legislation to the effect that both resident and non-resident investment funds (when undertaking the obligation to be taxed accordingly) fulfilling the necessary requirements will be treated equally under Danish tax law.

Bech-Bruun recommends that potential reclaims of source tax on dividends be filed in order to avoid that the claims become statutebarred before the ruling of the High Court of Eastern Denmark in the Fidelity Funds case pending before High Court.

Tags

EU law

Taxes and duties

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