Tax discrimination against foreign funds:

Light at the end of the tunnel*

*connectedthinking
Introduction

Note from Steffen Matthias, EFAMA and David Newton, PricewaterhouseCoopers LLP

This is our third report on the subject of how the EU single market is developing in the UCITS fund area.

Since our first report in 2001, significant progress has been made. It is quite clear that the European Court is prepared to strike down laws that frustrate the development of the single market where it can be shown that the law conflicts with a fundamental freedom enshrined in the EU Treaty (for example the free movement of capital).

If the first two reports demonstrate anything it is this: for change to happen, those adversely affected (such as cross-border fund managers or investors) need to make their case and let the European Commission or the European Court finish the job. It helps of course that the creation of a single UCITS fund market is a key policy objective, regarded by policy makers as delivering significant economic benefits (particularly for consumers).

Conversely, if those adversely affected by discrimination say nothing then nothing will happen!

We hope therefore that these reports are viewed as making a significant and positive contribution to the development of the EU single market.

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Contact Details

Steffen Matthias of EFAMA
+ 32 2 513 39 69
info@efama.org

David Newton of PwC
+ 44 207 804 2039
david.newton@uk.pwc.com
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- **Appendix I**: PwC/Fefsi June 2001 (as updated 2002)
- **Appendix II**: PwC/Fefsi Update January 2003
Light at the end of the tunnel
Previous PricewaterhouseCoopers LLP (PwC) and FEFSI reports on tax discrimination

PwC and FEFSI (now EFAMA) have published two previous reports highlighting the issue of discriminatory tax barriers against foreign funds (which qualify as UCITS funds) domiciled in one EU member state and sold into one or more other EU member states.

The two previous reports highlighted that promoters and managers of UCITS funds faced significant tax discrimination against the sale of their UCITS funds in a number of member states. Furthermore many of these discriminations were so severe as to make it virtually impossible to market foreign UCITS funds into certain EU member states.

The two previous reports are included in the Appendices to this report for reference purposes.

The market for UCITS funds has grown rapidly with the total number of funds rising from around 10,000 in 1993 to over 30,000 in mid 2005. Despite this increase the share of cross-border UCITS funds remains relatively modest, representing just 16% of the total number of funds. Undoubtedly one reason for this has been the presence of taxation rules which have represented significant barriers to the sale of UCITS funds from one country to another. As the European Commission pointed out in their Green Paper “On the Enhancement of the EU Framework for Investment Funds” (Com 2005 314 Final) published on 12 July 2005 “Tax constraints often generate additional administrative requirements and are powerful financial disincentives.”

This third report analyses the tax constraints that were previously reported, looks at progress in removing those constraints and identifies the remaining tax barriers to the effective operation of the EU single UCITS fund marketplace. The report also makes suggestions as to further areas requiring attention by the European fund industry and the European Commission.

Tax discrimination and the EU Treaty

These tax discriminations essentially take two forms:

- Tax reliefs that are only available to investors in domestic funds and not to those same investors in foreign-based UCITS.
- Tax rules which are applied only to foreign based UCITS and not to domestic UCITS which have some adverse tax effect on investors in foreign UCITS.

Such tax discriminations will, in almost every case, be illegal under the provisions of the EU Treaty as they will contravene the fundamental freedoms enshrined in the Treaty concerning the free movement of capital and/or the freedom to provide services within the EU.

Increasingly, EU financial services groups or businesses have brought cases of alleged Treaty infringement to the European Court of Justice (“ECJ”).

1 With effect from 2 March 2005 FEFSI changed its name to the “European Fund and Asset Management Association (EFAMA)” to reflect its new, and strengthened, membership structure incorporating management companies as direct members in addition to national associations. In this report all references made to the body are as EFAMA unless in relation to the previous joint reports of June 2001 (as updated 2002) and January 2003, which refer to FEFSI.

2 The original Directive for Collective Investment in Transferable Securities (UCITS) was approved by the Council of the European Communities on 20 December 1985 (Directive 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. The Directive was amended by the European Council on 21 January 2002 and is now known as “UCITS III”. 
The ECJ has invariably ruled that tax discriminations of the kind outlined above cannot be justified under the Treaty and are illegal. (See Appendix I for a detailed legal analysis).

In addition, EFAMA has itself written to EU finance ministers outlining the discriminations set out in the first two PwC/FEFSI reports, pointing out that such discriminations were incompatible with EU member states’ obligations under the EU Treaty. The EU Commission has also drawn attention to the discriminations against foreign funds.

**Light at the end of the tunnel: Favourable developments at last**

There has been, as a result of the reports and subsequent actions by EFAMA (as well as the influence of cases heard by the ECJ), a recognition on the part of EU member states that action was needed to eliminate many discriminations against foreign funds or tax reliefs that were only available to domestic funds.

In the last two and a half years, and particularly within the last eighteen months, as the table below shows there have been significant developments in Austria, France, Germany, Ireland and the UK to eliminate the most serious discriminations preventing foreign UCITS being sold to investors in these territories. In addition Denmark, which previously had one of the most discriminatory tax regimes against foreign funds, has now also undertaken reform.

![Figure 1: Favourable developments in tax discrimination](image)

<table>
<thead>
<tr>
<th>Country</th>
<th>Development</th>
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<tr>
<td>Austria</td>
<td>Under certain conditions, income tax rates favouring domestic funds abolished</td>
</tr>
<tr>
<td>France</td>
<td>Plan d’épargne en actions regime now allows foreign funds</td>
</tr>
<tr>
<td>Germany</td>
<td>Level playing field provided foreign fund promoters comply with the German Investment Tax Act</td>
</tr>
<tr>
<td>Ireland</td>
<td>Health contribution levy and social insurance tax applicable for certain foreign UCITS effectively abolished</td>
</tr>
<tr>
<td>UK</td>
<td>Some helpful changes to the offshore funds regime</td>
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</table>

These changes are outlined in this report (see pages 11-21). The elimination of some of the most serious discriminations in these mainstream and important UCITS markets is a significant and welcome step forward towards attaining a truly open EU single market in UCITS funds. For fund promoters and managers it means that, for the first time, it really is feasible to market a UCITS fund based in one EU member state into the other main EU member states without encountering the significant discrimination that previously existed. For the European funds industry this is a watershed development.

**Withholding taxes – A serious discrimination?**

The success in eliminating some of the most serious tax discriminations in the 15 original EU member states means that greater focus should now be placed on rather less serious, but nonetheless significant, discriminations and tax
inefficiencies that still remain, which tend to adversely affect adversely the attractiveness of foreign UCITS.

A potential source of discrimination is the tax credit systems in some EU member states that allow withholding taxes and domestic tax credits to flow through to domestic investors but only where that investor is investing capital via a domestic UCITS. In the diagram below, many of the investors would receive no credit for withholding taxes suffered by non-domestic UCITS. There are a number of ECJ tax cases on this type of issue and such provisions are generally incompatible with the EU Treaty (see page 25).

However it should also be noted (as highlighted in the diagram below) that UCITS based in different countries suffer varying rates of withholding tax determined solely by their country of residence. Such discrepancies can no longer be seen as compatible with the EU Treaty. The recent Fokus Bank case (see page 24) establishes the principle that if a country has a domestic system for the avoidance of double taxation on corporate dividends, and hence no withholding tax on domestic dividends, then the advantage of this must be extended to other EU investors. This extension would encompass foreign UCITS.

Fund boards or fund managers should consider making reclaims of withholding taxes suffered which, following the Fokus Bank decision, may be illegal (see pages 23-25).
Double taxation treaties
Many UCITS funds do not qualify for relief under double taxation treaties. By contrast, investors in such funds would usually qualify for a reduced rate of withholding tax if they invested directly in the underlying investments that the UCITS holds. For an equity fund, the resulting tax inefficiency can lead to increased charges in the order of 10-40 basis points. This is a complex issue as EU member states retain the right to negotiate bilateral double taxation treaties. However, there also is EU case law in this area and, if it can be shown that EU member states have negotiated a treaty that is incompatible with their obligations under the EU Treaty then the legality of that agreement or provision may be challenged. One way to remove the necessity for such bilateral agreements would be for the industry to press for a model treaty that would grant reduced withholding tax benefits to UCITS, where it can be shown that the underlying investors of the vehicle reside in an EU member state.

Onerous administrative requirements – would these too breach the EU Treaty?
Some countries also subject foreign-based UCITS to a requirement that they must comply with certain aspects of local law or the investor will suffer some form of tax penalty. Most fund promoters choose to comply with these requirements. There is, however, a body of ECJ case law that would suggest that overly burdensome administrative requirements, which are occurring to varying degrees in Austria, Belgium, Denmark, Germany and the UK, may be judged incompatible with the EU Treaty on the basis that they have the effect of restricting the development of the single market. The German, Austrian and UK tax systems in particular (all of which place significant obligations on foreign fund promoters selling UCITS to investors in their country), may be at risk under this case law (see pages 29-32).

Cross-border fund mergers
The overall reduction in the most serious tax discriminations has also highlighted the need to facilitate tax-free cross-border fund mergers. As it is now more feasible than ever before to market UCITS on a cross-border basis, attention is being focused on the ability of the industry to move to an EU market where more funds are sold on a cross-border basis. There is a broad consensus that the EU UCITS market is very fragmented. Average fund sizes are around one fifth of those found in the US market and consequently there needs to be a significant rationalisation of these funds to move towards the economies of scale seen in the US market-place. One impact of the current fragmented market-place is that production costs are higher than necessary (see pages 35-36).
A fund merger directive?

PwC is working on a separate report on the issue of fund mergers. It is almost certain that countries which permit domestic UCITS fund mergers to occur on a tax-free basis, but do not extend this to mergers with foreign UCITS, are likely to be judged ultimately in the Courts to have regimes that are incompatible with the EU Treaty. However the most rapid way of ensuring progress for countries which do not permit tax-free fund mergers to occur would probably be for the EU funds industry to press for a fund merger directive that mandates member states to allow such mergers to occur according to a clear regulatory framework and in a tax-free manner. This is work in progress for the industry (see page 36).

New entrants to the EU

Since the first two reports were prepared the EU has enlarged from 15 to 25 member states. Many tax discriminations that existed in the original 15 EU member states had their origins in the history of their tax systems which pre-dated the single market. Not surprisingly therefore, many of the new entrants have similar tax discriminations against foreign UCITS. However whilst it is important that these discriminations be eliminated, many of these markets are not yet as commercially significant as the original 15 EU member states for the funds industry. PwC and EFAMA plan to analyse the tax barriers in the new EU countries in a separate report in the future.
Update on tax discrimination against foreign funds

Real and positive progress, particularly in the last thirty months

The key message is that in the last 30 months, developments in eliminating much of the existing tax discrimination in three major EU member states (France, Germany and the UK) mean that, for the first time, it is feasible from a tax perspective, to have one fund that can be sold into each of these countries at the same time without the significant tax disadvantages that existed previously. In addition there has been significant and effective reform in Ireland as well as tax reform in Austria that moves Austria towards a level playing field between domestic and foreign funds. Denmark has also introduced reforms, albeit with onerous requirements on foreign UCITS promoters to produce Danish information.

In the view of PwC/EFAMA it would be no exaggeration to say that these are watershed developments in the evolution of the single market. As it is now more feasible to have tax-efficient cross-border funds, this in turn will create more pressure to achieve cross-border fund mergers.

The remainder of this section looks at the changes in the field of tax discrimination since our last report in January 2003 and cross-border fund combinations which are likely to be tax-efficient.

What discriminatory tax barriers exist?

The tax discriminations that face UCITS funds being sold from one country into another broadly take two forms.

- Tax reliefs that are only available to investors in domestic funds and not to those same investors in foreign-based UCITS.
- Tax rules which are applied only to foreign-based UCITS and not to domestic UCITS which have some adverse tax effect on investors in foreign UCITS.

Each EU member state must ensure that its tax system is consistent with the provisions of the European Union consolidated Treaty. In particular, the EU Treaty enshrines two important and fundamental freedoms: Article 48 (free movement of services) and Article 56 (free movement of capital).

While there are some minor exceptions, in general, if EU member states have tax rules that either favour investment in domestic funds, or impose a harsher regime on foreign-based funds, these will be a contravention of the fundamental freedoms in Articles 48 and/or 56.

The ECJ, in a number of recent cases, has steadfastly upheld the supremacy of these freedoms over EU member states’ sovereign rights to determine their own direct tax rates and systems.
In particular, the defences put up by EU member states and rejected by the ECJ include:

- Tax rules which, were they not in place, would lead to a loss in revenue to the EU member states concerned. In the Verkojeen case this was rejected on the basis that “a reduction in such tax revenue cannot be regarded as an overriding interest in the public interest.”
- That the particular discrimination is necessary to prevent tax avoidance. This has been decisively rejected by the European Court: “the risk of tax evasion cannot be relied upon as a defence for a discriminatory tax measure.”
- That the taxpayer might have avoided the discrimination had he ordered his affairs in a different way. Again this has been rejected by the ECJ.
- That a particular tax rule is required because the EU member state cannot ensure that an overseas UCITS product is taxed in at least as onerous a fashion as the domestic product. This kind of argument was rejected in the Safir case.

The current position under EU law therefore is that EU member states will find it extremely difficult to justify any tax discrimination against a foreign UCITS product, and most tax rules, which have the effect of discouraging investment in foreign UCITS funds, will be illegal.

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**Tax discriminations – the current state of play**

PwC has updated the map of European tax discriminations against foreign UCITS products. The following table and commentary set out the progress on previously noted tax discriminations, current to August 2005. Whilst there are some new discriminations that have emerged, significant progress has been made in removing tax discriminations against foreign funds in a number of countries.

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1 Staatssecretaris van Financizn vBGM Verkooijen – C-35/98
2 Commission vs France – Avoir Fiscal C-270/83
3 Jessica Safir vs Skattemyndigheten i Dalamas Län – 118/96

“In the view of PwC/EFAMA it would be no exaggeration to say that these are watershed developments in the evolution of the single market.”
“The current position under EU law therefore is that member states will find it extremely difficult to justify any tax discrimination against a foreign UCITS product, and most tax rules which have the effect of discouraging investment in foreign UCITS funds will be illegal.”

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<tr>
<th>Country</th>
<th>Discriminatory barriers/other tax related barriers</th>
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<tr>
<td>Austria</td>
<td>‘Whiter than white’ foreign UCITS</td>
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<tr>
<td></td>
<td>i. Existing income tax regime</td>
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<tr>
<td></td>
<td>ii. Safeguard tax</td>
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<tr>
<td></td>
<td>‘White’ foreign UCITS</td>
</tr>
<tr>
<td></td>
<td>i. Existing income tax regime</td>
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<tr>
<td></td>
<td>ii. Safeguard tax</td>
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<tr>
<td></td>
<td>‘Black’ foreign UCITS</td>
</tr>
<tr>
<td></td>
<td>i. Existing income tax regime</td>
</tr>
<tr>
<td></td>
<td>ii. Safeguard tax</td>
</tr>
<tr>
<td>Belgium</td>
<td>Tax on distributions to individual investors</td>
</tr>
<tr>
<td></td>
<td>i. Participation exemption</td>
</tr>
<tr>
<td></td>
<td>ii. Benefit from foreign tax credits</td>
</tr>
<tr>
<td></td>
<td>iv. New annual tax on net subscriptions</td>
</tr>
<tr>
<td>Denmark</td>
<td>Foreign Fund legislation</td>
</tr>
<tr>
<td>Finland</td>
<td>None noted</td>
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<tr>
<td>France</td>
<td>Plan d’Epargne en Actions (‘PEA’)</td>
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<td></td>
<td>i. Franchise relief</td>
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<tr>
<td></td>
<td>iii. French imputation tax system</td>
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<td></td>
<td>iv. Fixed income securities</td>
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### Figure 1 (continued): Measures previously identified or new measures identified

<table>
<thead>
<tr>
<th>Country</th>
<th>Discriminatory barriers/other tax related barriers</th>
</tr>
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</table>
| Germany   | i. New Investment Tax Act  
|           | ii. New provision on fund mergers  
|           | iii. Increase of publication requirements under German principles |
| Greece    | Investment funds legislation which penalises foreign UCITS |
| Ireland   | Taxation of Irish investors in offshore UCITS |
| Italy     | i. Capital gains tax  
|           | ii. Investment in Italian securities by foreign UCITS |
| Luxembourg| None noted |
| Netherlands| Reclaim of foreign withholding taxes & the preferential tax regime for Dutch investment funds |
| Portugal  | Different income tax regimes for individual investors |
| Spain     | None noted re EU funds |
| Sweden    | New consideration - Fund mergers taxable on investors if a foreign fund is involved (See section 5 for further commentary) |
| UK        | i. Offshore fund legislation  
|           | ii. UK Imputation tax system |

### Key for Figure 1
- Discriminatory measures identified last year have now been completely addressed.
- Some favourable movement has occurred to reduce or eliminate discrimination but significant discrimination or barriers still remain.
- No new discriminatory measures but the status quo persists, which may mean that existing discriminatory measures remain unchanged or largely unchanged.
- New discriminatory measures introduced or proposed.
Discriminatory tax barriers facing the EU funds industry: Country Update

Brief details are set out below in relation to each of the countries concerned (see Figure 1).

Austria

In order to understand the current position, it is first necessary to understand that the Austrian tax authorities use the following criteria to categorise Austrian investors’ interests in foreign UCITS:

- ‘Whiter than white’ funds – foreign UCITS that have an Austrian tax representative and publish all of the following data via the “Oesterreichische Kontrollbank” (OeKB):
  - daily interest income figures
  - the taxable portion in the case of a distribution
  - yearly deemed distribution income figures
  In addition, the yearly deemed distribution income figures need to be filed with the Austrian Ministry of Finance (MoF).
- ‘White’ funds – foreign UCITS which are registered for public distribution in Austria and have an Austrian tax representative filing the yearly deemed distribution income figures with the MoF.
- ‘Black’ funds – foreign UCITS without an Austrian tax representative.

Whiter than white UCITS

From 1 July 2005, foreign ‘whiter than white’ funds now achieve the same position as domestic UCITS under the same legislative regime; the result being that an Austrian investor will now suffer 25% flat rate final taxation, without having to submit a return or pay the safeguard tax.

However, it should be noted that such parity of treatment for the investor can only be achieved if the foreign fund provider undertakes to comply with the fairly onerous administrative burdens set out above. Section 4 of the report sets out whether such administrative burdens may be breach of the EU Treaty.

White UCITS

Foreign ‘white’ UCITS are still subject to a separate regime, and can only achieve a 25% flat rate final taxation if they meet the following further conditions:

- The foreign UCITS must appoint a local tax representative to calculate deemed income distributions on an annual basis and provide the OeKB with this information four months after the financial year end.
- Net interest income figures according to Austrian tax law must be provided by the fund to the OeKB on a daily basis and information on Austrian withholding tax on all taxable portions of distribution paid to investors must also be provided to OeKB.
In addition, an investor in a white fund will be taxed differently to an investor in an Austrian domestic fund in the year of acquisition and disposal. Further, the investor may have to suffer the safeguard tax of 1.5% of year end net asset value albeit that this may ultimately be refunded to the investor by filing a tax return.

In summary, for white funds there remains a differential tax treatment for investors and this is likely to be regarded as an illegal discrimination under the EU Treaty should such a case be taken.

In addition, and as for the whiter than white funds, the regime does involve a reasonably onerous administrative burden for both the fund promoter and the investor which may, for the reasons set out in Section 4, be in breach of the EU Treaty.

Foreign UCITS funds with no Austrian tax representative (“black funds”)

UCITS funds based in other EU member states which do not have an Austrian tax representative continue to be taxed on a wholly different and more onerous basis to Austrian domestic funds. As a result, Austrian investors in foreign UCITS will be taxed on realised and unrealised capital gains in the fund, which would be broadly tax-free were the funds based in Austria. While such funds are not publicly available, Austrian investors may acquire an interest either via a direct approach to the foreign fund manager or as a result of moving to Austria having acquired an interest in such a fund elsewhere in the EU.

While the Austrian investor is to some extent able to mitigate some, but not all, of the Austrian tax disadvantages arising from the investment in the black fund by filing an Austrian tax return, in practice this would require detailed information from the fund promoter. However even if the investor manages to achieve this, he will never be able to be taxed on exactly the same basis as an Austrian domestic fund (for similar reasons to white funds above). As for the other categories of Austrian fund above, the administrative obligations may also be in breach of the EU treaty – (see Section 4).

Belgium

A new discriminatory measure - annual tax on the net asset value of UCITS under foreign law

Since 1994 UCITS resident in Belgium have been taxed annually on the basis of their net asset value ‘distributed’ in Belgium at 31 December of the preceding year. A law passed on 22 December 2003 extended the scope of this “annual tax” to include foreign UCITS that are ‘distributed’ in Belgium (via Belgian financial intermediaries).

For the tax year 2004 (from 1 January 2004) the rate of this annual tax was 0.06%. For the tax year 2005 (from 1 January 2005) this rate has increased to 0.07%, and is set to increase further in future. Notably, while the tax is applicable to foreign UCITS distributed in Belgium irrespective of the identity of the
investors, for sub-funds or share classes set up for institutional investors tax will be due at a rate of only 0.01%. However, in the absence of a public offering in Belgium, funds marketed exclusively to institutional investors typically remain out of scope of the tax as such funds will not be registered with the Belgian Banking and Insurance Commission.

Clearly, this regime requires the retention of complex records tracing the proportion of foreign UCITS net asset value distributed in Belgium.

On the basis that domestic and foreign UCITS are essentially similar products this measure appears discriminatory as the new law places a wider burden on foreign UCITS and is likely to impede the promotion of UCITS into Belgium therefore deterring Belgian investors from investing capital in foreign UCITS. The reasons for this are twofold:

i. The tax is suffered at the fund level and consequently all investors (Belgian and foreign) of the UCITS are subject to Belgian annual tax. As such, there is a clear risk of double taxation on net subscriptions in Belgium where the jurisdiction in which the UCITS is resident applies a similar “taxe d’abonnement”. This risk makes the funds affected less attractive to Belgian (and foreign investors) than equivalent Belgian domestic UCITS which are only subject to this type of tax once and which have less onerous record keeping requirements.

ii. The application of this law places a different and more onerous administrative requirement on foreign UCITS promoters.

While ii. above relates more to an administrative burden on foreign UCITS (as discussed in Section 4), i. above is likely to be regarded as an illegal discrimination should the matter be heard by the ECJ.

Denmark

The Danish Parliament passed a Bill in May 2005 that aimed to remove the tax barriers previously identified. This is an important development. Under the previous Danish tax regime, the Danish market has in general been perceived as difficult to penetrate for foreign UCITS. Whether the changes made represent a formal removal of the tax barriers rather than a genuine removal is being questioned by the foreign UCITS promoters. This is on the basis that in order to have the same resultant tax treatment for foreign UCITS as compared to Danish UCITS, the foreign UCITS must comply with Danish tax reporting requirements. As such, in practice the foreign UCITS must invest in IT solutions or incur cost in order to achieve parity of tax treatment. Again this points to an onerous administrative burden (as discussed in further detail in Section 4) which may be illegal on the basis that it represents a disproportionate burden for foreign promoters with no acceptable justification under EU law.

In addition under the new rules if the UCITS fails to comply with the asset allocation restrictions as defined under
Danish tax law the Danish investors in foreign UCITS will be subject to a less beneficial tax regime for a period of five years.

For all these reasons we anticipate that Denmark will continue to be a difficult market for foreign fund promoters to penetrate for the foreseeable future.

**France**

Most of the discriminatory barriers discussed in the previous reports have been addressed by the 2004 and 2005 Financial Bills. Franchise relief has been fully addressed while the other main changes are discussed below.

**Plan d’Epargne en Actions (PEA)**

Until 2004, a French investor in a foreign UCITS could not qualify for access to the taxation benefits of investment in a PEA. This discrimination has now been substantially abolished, as investment via a foreign UCITS invested in French or EU equities was recognised as a qualifying investment by the Financial Bill 2004; this Bill having been implemented on 1 January 2005.

This is a significant development as the previous PEA regime amounted to a serious tax barrier to the sale of foreign UCITS into France, which required, in many cases, foreign UCITS managers to set up French funds especially for the purpose of accessing French investors.

**French imputation tax system**

Significant modifications have been made to the dividend tax system. Under the new regime a French investor is generally subject to tax on only 50% of a gross dividend received, whether the dividend is paid by a company resident in France, the EU or a Treaty partner jurisdiction (provided the latter is subject to a form of corporate tax). Prima facie this does not apply to distributions made by UCITS. However, if specific dividend coupons are identified to show that a distribution is sourced from underlying income of the UCITS which meets the above conditions, the French investor will benefit from the 50% allowance. This applies to UCITS resident in other EU member states as well as French UCITS and, as such previous discrimination has now been removed, as from 2005 onwards.

**Fixed income securities**

Until 2004 only French fixed income security payments received by individuals could be subject to a flat rate withholding tax of 16% (and 10% of social contributions). This withholding mechanism was also available for interest payments through a French UCITS provided the coupon was specifically identified as an interest coupon.

The 2005 Financial Bill extended this flat rate withholding mechanism to fixed income payments sourced from any European Economic Area (“EEA”) country. The withholding regime can now apply even if the paying agent is established in the EEA (apart from Liechtenstein).
However, there are continuing discussions as regards practical implementation for payments derived from foreign UCITS.

**Germany**

In November 2003, Germany passed the Investment Tax Act, which applies to years beginning after 31 December 2003. The new fund tax legislation introduces major changes which assist in the abolition of discriminatory tax barriers in the following areas:

- Dividends received by either domestic or foreign funds (including UCITS) which are derived from equity are now tax-free for corporate investors and half taxable for non-corporate investors. Previously this status was only available to German investors in domestic UCITS.
- Likewise, capital gains realised in the fund from the sale of equity are tax-free for corporate investors and half taxable for non-corporate investors; a status which was previously only available to German investors in domestic UCITS.
- The "Aktiengewinn" ("equity gain") regime, previously only available to domestic UCITS, has been introduced for foreign funds (including UCITS). Broadly, this calculates a non-taxable amount upon sale or redemption of a unit in the fund in relation to realised and unrealised capital gains and dividends received.
- The former taxation categories of high-, medium- and low-level funds are abolished and two types of funds (transparent and non-transparent) have been introduced.

Most noteworthy is the fact that the discrimination against foreign funds (including UCITS) with regard to dividends and capital gains from the sale of equities has been abolished. In addition, the new lump-sum taxation of non-transparent funds applies to both foreign and German funds (including UCITS).

The enhanced fund reporting requirements impose some burdens for foreign UCITS to be marketed to German investors. While the new requirements apply to both foreign “tax transparent” funds (including UCITS) and likewise to German “tax transparent” funds, the intention is that the results of the fund must be reported under German generally accepted accounting practice for tax purposes (German tax “GAAP”). This places an additional and onerous requirement on promoters of German and foreign UCITS whose administration system is not yet capable of producing figures in line with German tax GAAP standards. The possibility that onerous administrative requirements may be in breach of the EU Treaty is considered further in Section 4 of this report.

**Greece**

The discriminatory regime identified in our original 2001 report in relation to capital gains tax has been addressed.
Ireland

The Irish tax authorities have enacted legislation which has removed the previously identified discriminatory barrier to the distribution of foreign UCITS into Ireland. Under the old regime, a charge to a health contribution levy and social insurance applied to certain foreign funds (including UCITS). Effectively, under the new regime, such charges no longer apply in respect of Irish investors’ interests in foreign funds that are located not only in another EU member state, but also in an EEA state or an OECD country with whom Ireland has entered into a double taxation treaty.

Italy

The capital gains discrimination previously reported remains in force. However, new provisions have been introduced in order to facilitate investment in Italian securities by foreign UCITS. The previous regime included exemptions from Italian tax on certain types of income for non-Italian investors that were resident (for double taxation treaty purposes) in states which allow the exchange of information (EOI) between the tax authorities. The requirement of residence for Treaty purposes has now been removed. As such the exemption from Italian tax is now available to all EU foreign investors, including UCITS, which are resident in countries which allow the EOI between tax authorities. Therefore, in this respect the EU discriminatory barrier arising under the previous regime has been largely addressed.

Netherlands

Reclaim of foreign withholding taxes – “Dutch investment institution status”

In relation to the previously identified discrimination, the Dutch Advocate General has confirmed a 2003 ruling of the Dutch lower court, concluding that the preferential regulation governing the reclaim of foreign withholding taxes for ‘Dutch investment institutions’ is a restriction of the free movement of capital principle in the EU Treaty. The Supreme Court has yet to rule on this issue and therefore the discrimination previously reported remains.

The Dutch Ministry have also undertaken a review of “Dutch investment institution status”. In order for such status to apply (which confers certain tax benefits), several conditions have to be met, which could be considered to be discriminatory against both foreign UCITS and foreign investors. As a result, the Ministry announced a relaxation of the shareholder requirements (i.e. the regime will become more open to non-Dutch investors). Furthermore, a review of whether the regime may also become applicable to non-Dutch entities is expected in the near future (with a proposal expected during autumn 2005).

Portugal

The regime previously reported remains in place. It could be argued to be discriminatory, as no Portuguese paying or collecting agent exists in relation to the foreign UCITS sold within Portugal.
Spain

No further changes have been made to the system previously reported. Spain retains its discriminatory regime against non-UCITS funds considered to be in ‘tax havens’, but this does not include discrimination against UCITS from other EU member states.

United Kingdom

Changes to the UK offshore funds regime were applicable to accounting periods ending on or after the date of UK Royal Assent (22 July 2004). While addressing some administrative difficulties inherent in the previous regime with regard to foreign UCITS, the changes have not gone so far as to fundamentally discard the process which foreign funds must follow to obtain certification as a distributing offshore fund.

The changes brought in have the following effects:

• Each individual share class or sub-fund of a foreign UCITS may now be treated as a separate offshore fund for the purposes of applying for certification as ‘distributing’. Therefore no longer are all sub-funds/classes of interest required to meet the distribution criteria in order that UK investors obtain the same tax treatment as if they were to invest in a UK fund. Previously UK investors would be penalised if any sub-fund which was part of the UCITS failed to obtain distributor status (even though that sub-fund may have had no UK investors).

• There have been changes regarding the calculations required for applications, which allow such applications to more closely follow the accounts.

The requirements of certification are, as such, intended to be less onerous for the promoter of the foreign UCITS. However they still remain discriminatory under EU law, as unless “offshore funds” obtain distributor status, investors in foreign funds (including UCITS) are taxed under a less favourable regime compared to domestic funds. As such, foreign UCITS are still required to undergo relatively onerous tax compliance procedures, and will still need to pay cash distributions in order to gain distributor status.

“...foreign UCITS are still required to undergo relatively onerous tax compliance procedures, and will still need to pay cash distributions in order to gain distributor status.”
22 Light at the end of the tunnel
Withholding taxes, tax credits and double taxation treaties – Another discrimination?

The analysis above indicates that, for the first time, it is possible to say that the principal barriers to the sale of cross-border funds in a number of countries have been reduced. However, particularly for equity funds, there do remain some discriminatory differences in treatment mainly related to the different treatment of withholding taxes, tax credits on dividends, and the ability to qualify for the benefit of double taxation treaties. Each of these is set out in more detail below.

Withholding taxes – a serious tax discrimination?

In many EU member states, dividends distributed from a domestic company to domestic investment funds are either not subject to withholding tax or the domestic fund can claim a (full or partial) refund of this withholding tax. The domestic policy objective for such systems is the avoidance of double taxation on corporate profits as dividends are paid out of taxed profits of the company.

By contrast, dividends distributed from a domestic company to a foreign UCITS fund suffer a final withholding tax. This tax may or may not be reduced by a bilateral double tax treaty, but often the withholding tax is irrecoverable and so the foreign fund is subject to higher taxation than a comparable domestic fund.

The following table illustrates differences between the treatment of dividends paid to domestic and foreign UCITS in some EU countries.

<table>
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<th>EU member state</th>
<th>Is there a withholding tax on domestic dividends to domestic UCITS funds?</th>
<th>Is there a higher rate of withholding tax on dividends to foreign UCITS funds?</th>
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<td>Austria</td>
<td>25%</td>
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<td>Belgium</td>
<td>Withholding refunded at domestic UCITS fund level</td>
<td>Yes</td>
</tr>
<tr>
<td>Denmark</td>
<td>Usually exempt</td>
<td>Yes</td>
</tr>
<tr>
<td>France</td>
<td>Nil withholding tax</td>
<td>Yes</td>
</tr>
<tr>
<td>Germany</td>
<td>Withholding refunded at domestic UCITS fund level</td>
<td>Yes</td>
</tr>
<tr>
<td>Ireland</td>
<td>Nil withholding tax</td>
<td>No</td>
</tr>
<tr>
<td>Italy</td>
<td>Nil withholding tax</td>
<td>Yes</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>20%</td>
<td>No</td>
</tr>
<tr>
<td>Netherlands</td>
<td>Withholding tax fully refundable at domestic UCITS fund level</td>
<td>Yes</td>
</tr>
<tr>
<td>Spain</td>
<td>Withholding tax fully refundable at domestic UCITS fund level</td>
<td>Yes’</td>
</tr>
<tr>
<td>UK</td>
<td>No withholding tax on dividends</td>
<td>No</td>
</tr>
</tbody>
</table>

In fact, this position is even more complex, since the rate of withholding taxes levied by some countries will vary depending on where the foreign UCITS is based. The diagram overleaf illustrates this in the case of France.

How can it be compatible with the single market and the EU Treaty to have such divergent withholding tax rates? Generally such divergences should not be compatible with the single market principles where a lower rate of withholding is levied on a dividend paid to a comparable domestic investor, e.g. a domestic UCITS.

The main authority for this conclusion is the recent Fokus Bank case (E1/04). The principle established by the case is that if there is a domestic system for the 1 German and non-German funds are allowed to pass on to their investors the withholding tax that the funds have suffered, as tax credits for the investors. A potential for discrimination against the non-German fund remains in triangular cases, where the dividend source country is different from the fund domicile.

2 The rate in itself is currently the same (15% for local funds and 15% for foreign funds unless the treaty rate is lower), however the local withholding is refundable and the foreign one is, from a Spanish perspective, a final tax to a non-resident. There is one case where the local withholding is nil and foreign withholding would be 15%, although this is not a normal situation; this happens when the Spanish fund holds more that 5% of the shares in the company for more than one year.
“Denying the benefit of a tax credit to foreign shareholders places them at a disadvantage when pursuing investments in Norwegian joint stock companies as compared to shareholders resident in Norway. Therefore, the legislation at issue constitutes discrimination prohibited by Article 40 EEA.”

avoidance of double taxation on corporate dividends, usually in the form of a zero or reduced withholding tax or a refund of the withholding tax to the domestic investors or domestic UCITS fund, then the advantages of this must be extended to other EU investors, including UCITS funds.

The European Free Trade Association ("EFTA") Court specifically commented at paragraph 34:

"Denying the benefit of a tax credit to foreign shareholders places them at a disadvantage when pursuing investments in Norwegian joint stock companies as compared to shareholders resident in Norway. Therefore, the legislation at issue constitutes discrimination prohibited by Article 40 EEA".

Although the case was heard in the EFTA Court, the principles underlying the case create a precedent in the ECJ and Article 40 is equivalent to Article 56 of the EU Treaty (the free movement of capital provision).

From the EU member states surveyed in the table on page 23, the systems in all except Austria, Ireland, Luxembourg and the UK appear, prima facie, to give rise to tax discrimination against foreign UCITS funds.

How much is the Fokus Bank principle worth to EU equity UCITS funds?

According to the Financial Times, dividend yields on EU dividends are currently around the 2% level.

Foreign UCITS funds are suffering a range of 15-30% withholding tax rates on EU dividends. Assuming a full exemption or refund from withholding taxes for domestic UCITS, this would suggest that foreign UCITS are suffering up to 30-60 basis points of excess withholding tax in each year (15-30% x 2%). A reduction of such costs would clearly boost the annual investor returns on fund assets. Given that reclaims should be possible in respect of prior years, there could also be the capacity for additional one-off benefits to fund performance.

Fund boards and fund managers will need to determine the appropriate actions to recover this withholding tax. However, in considering this issue, fund boards and managers will generally have...
"... EU member states should be aware that their sovereign right to negotiate bilateral double taxation treaties is likely to be subject to the proviso that those treaties should respect the fundamental freedoms within the EU Treaty."

In addition EU member states that allow a credit at the domestic investor level for foreign withholding tax suffered by a domestic UCITS should extend this flow-through of credit to the investor when a distribution is received from a foreign UCITS. Again the UK would be an example of a country that does not permit the credit flow-through of foreign withholding taxes from a foreign UCITS (whereas such credit flow-through does occur for domestic UCITS receiving foreign dividends which have suffered foreign withholding tax).

Qualification for double taxation treaties

EU UCITS funds based in Luxembourg and Dublin do not qualify for the benefit of double taxation treaties. This means that in relation to dividend income, such funds will suffer withholding taxes at rates of up to 30%.

The agreement of double taxation treaties with countries outside the EU is a bilateral matter between the EU member state and that third country. Where a UCITS fund is not subject to income or corporation tax in its home territory, the other treaty partner is likely to take the view that the UCITS should not benefit from a reduced withholding tax under the relevant Treaty. This is a problem that Luxembourg and Irish funds (constituted as corporate bodies) face. Yet in so far as all the investors in these funds are based in other EU member states, then if they invested directly into the third country they would (in all probability) qualify for

3 Staatssecretaris van Financien v BGM Verkooijen C-35/98 and Manninen C-319/02

a fiduciary responsibility to their investors to maximise returns such that, where a reclaim can validly be made and is not out-weighed by the associated costs, it would be difficult not to seek a recovery.

The differential withholding tax rates faced by UCITS funds is a remaining and measurably significant reason for continuing fragmentation in the EU funds market. The resolution of this withholding tax inefficiency has the capacity to make the creation of a truly single European fund market significantly easier.

Tax credits on dividends – Another tax discrimination?

A small number of EU member states impute a tax credit on any dividends paid to domestic investors. The aim of such systems is to give investors some reduction in their income tax liability on dividends (through the issuance of a tax credit) to reflect the fact that those same dividends have already suffered some corporation tax.

Generally such imputed tax credits are lost when the dividend flows through a foreign UCITS, whereas usually arrangements are in place to protect the credit when it flows through a domestic fund. The UK would be an example of this. Again, such systems are likely to be discriminatory and although there have been a number of European court cases pointing to this conclusion (for example Verkooijen, Manninen), further cases are probably required before this adverse effect for funds sold on a cross-border basis can be eliminated.
the reduced withholding under double taxation treaties. So in negotiating double taxation treaties, EU member states could seek to agree with treaty partners that where the underlying investors in a domestic UCITS are based in the EU, then the reduced rate of withholding should apply. There is no reason in principle why third countries should not accept this line of argument though the US has been somewhat resistant to date.

This is also an issue that would benefit from an EU Commission initiative, perhaps to develop some suitable model treaty wording that EU member states should seek to use in negotiating double taxation treaties. It may also be beneficial if the Commission could be mandated by EU member states to negotiate with third countries (as occurred in the agreement of the Savings Directive) to seek agreement in principle with those third countries that they will be prepared to agree to double taxation treaties with EU member states that respect the single market and grant Treaty benefits to UCITS funds (perhaps subject to a test that their investors reside in Treaty-qualifying states).

Finally EU member states should be aware that their sovereign right to negotiate bilateral double taxation treaties is likely to be subject to the proviso that those treaties should respect the fundamental freedoms within the EU Treaty. In the “Open Skies” case the ECJ determined that EU member states were not free to assign aircraft landing slots bilaterally, in this instance with the US, without regard to the requirements of the EU Treaty to open those opportunities to entities in other EU member states. Although this is also emerging European jurisprudence, an EU member state that seeks to agree that its own domestic UCITS funds will obtain treaty rights unless the investors reside in another EU member state will most likely be at risk of having breached its own treaty obligations. The current UK Treaty with the US contains such a clause and it will be interesting to see if any taxpayer decides to take a case on this.

4 Commission v UK (c-466198). Similar cases were also taken against most other EU member states.
“This is also an issue that would benefit from an EU Commission initiative, perhaps to develop some suitable model treaty wording that EU member states should seek to use in negotiating double taxation treaties.”
Light at the end of the tunnel
Onerous administrative requirements placed on foreign fund providers – EU Treaty restrictions?

Special tax rules for foreign fund promoters

EU member states retain the right to set tax law in relation to direct taxation (business and personal income taxes), although it is now accepted case law that such taxation regimes must be compatible with the fundamental freedoms of the EU Treaty.

The single market in financial services and particularly in the UCITS field means that increasingly, individuals in one EU member state may choose to buy funds or other financial services products in another EU member state.

When nationals in one EU member state (“the home country”) do exercise their right to invest in a UCITS elsewhere in the EU, the taxing authorities in the home country of the investor have to devise rules to tax such investments. This may sound straightforward but frequently the taxation of similar domestic products will follow particular local rules, for example in relation to the classification between income and capital gains and the timing of income recognition. Local providers of UCITS can be requested to provide investors and the taxing authorities with the necessary information to enable the investors’ tax affairs to be settled and the correct amount of tax to be paid.

However when tax authorities are dealing with UCITS which are domiciled in another EU member state, the fund or fund promoter will not always have the information necessary to report figures that are compatible with each other member state’s tax system.

To deal with this, a number of EU member states have legislated for foreign fund promoters, in effect, to provide information on a local taxation basis so that investors can report the correct amount of income. Countries with detailed rules such as this include Austria (in relation to ‘whiter than white’ funds), Belgium (in so far as complex tracing records are required in relation to the annual tax on amounts distributed in Belgium), Denmark, Germany and the UK.

Were all EU member states to adopt the same approach, it is conceivable that a fund promoter selling UCITS into all 25 member states would have to prepare 25 different sets of tax data, one for each state. These types of rules require fund managers conducting business on a cross-border basis to spend considerable time and expense complying with these local rules. Frequently the penalties for a failure by the fund promoter to adequately comply include the penalisation of the investor through an increase in his/her tax charge and/or fines on the fund promoter, manager or their local representative.
From the viewpoint of the local taxing authorities such requirements are put in place to assist in the orderly running of their tax systems, so that they can easily collect the right amount of taxation from their own nationals in relation to investments in foreign UCITS.

Nonetheless, these rules are sometimes onerous and have the overall impact of making investment in non-domestic EU UCITS more onerous for the fund promoter or manager and potentially also for the investor.

The question that arises in relation to these rules is “To what extent is it acceptable under the EU Treaty for an EU member state to place onerous administrative tax reporting requirements on foreign UCITS providers?”

Cases heard by the European Court

Many of the ECJ cases in this area do not relate to tax rules but to local requirements to demonstrate equivalence to a local product, adherence to local marketing rules or demonstrating that personnel involved in the cross-border business are appropriately qualified.

In general the ECJ has ruled that such local restrictions cannot be permitted under the EU Treaty. In a series of cases taken by the European Commission in relation to the activities of cross-border private security businesses and detective agencies1, the European Court rejected arguments by member states that local home country measures and rules were required to ensure public security and well-being. A factor in most of these cases was the existence of adequate checks in the EU member state where the business was located.

In a further case involving the cross-border sale of Cassis de Dijon to Germany2 as far back as 1978, the local German authorities had sought to restrict the sale of Cassis de Dijon inter alia “to avoid the proliferation of alcoholic beverages with a low alcoholic content, since, in its view, such products may more easily induce a tolerance towards alcohol than more highly alcoholic beverages”. The ECJ flatly rejected this (rather interesting) contention stating “There is therefore no valid reason why, provided that they have been lawfully produced and marketed in one of the member states, alcoholic beverages should not be introduced into any other member state; the sale of such products may not be subject to a legal prohibition on the marketing of beverages with an alcohol content lower than the limit set by the national rules”.

Although this case was dealing with a legal prohibition unless the alcoholic content were increased, the effect of the tax rules applying to the sale of the foreign UCITS into certain EU member states is a de facto prohibition on the sale of the product since the adverse tax result for the investor in investing in such a fund would surely mean that the investor would not purchase the product.

1 These cases include The European Commission v Italy C-283/99, The European Commission v Spain C-114/97 and The European Commission v Netherlands C-189/03

2 Rew-Zentral AG v Bundesmonopolverwaltung fur Branntwein C-120/78
The Futura Case

A significant tax case in this area heard by the ECJ is the Futura case. This case involved a French company with a trading branch in Luxembourg which in early years sustained losses. Under Luxembourg tax law, a turnover based apportionment of the overall French company loss was permitted to be made to the Luxembourg branch which then carried these losses forward. Upon the French company realising profits, the offset of brought forward losses against Luxembourg branch profits was only possible if the non-resident taxpayer had ensured that “accounts complying with Luxembourg rules (“proper accounts”) for the years in question had been made and kept in Luxembourg”. The French company did not keep such proper local accounts and accordingly the Luxembourg authorities refused to allow the losses to be carried forward to be set against profits of the Luxembourg branch. The French company appealed contending that the Luxembourg rules amounted to a breach of Article 43 which prohibits restrictions on the freedom of establishment on the basis that their rights were subject to the condition that the losses should be related to the maintenance of proper accounts within the country.

The courts held that it was not contrary to Article 43 to have rules relating the losses and profits to be related to activity in Luxembourg but Article 43 “does preclude the carrying forward of losses from being made subject to the condition that, in the year in which the losses were incurred, the taxpayer must have kept and held in that state accounts relating to his activities carried on there which comply with the relevant national rules. The member state concerned may, however, require the non-resident taxpayer to demonstrate clearly and precisely that the amount of the losses which he claims to have corresponds to the losses actually incurred in that state by the taxpayer”.

Summary of case law

Although this is a developing area of European law, and there is only one major tax case relating to the ECJ’s approach to administrative requirements placed upon non-domestic entities, it is possible to summarise the case law to date as it might relate to UCITS.

The main arguments of EU member states would be that the tax rules as they relate to foreign UCITS are necessary to meet the imperative interest of fiscal supervision, originally recognised by the European Court in the Cassis de Dijon case, mentioned above. Specifically EU member states would be likely to contend that they needed to classify the income and capital gains at the fund level in order to levy taxation at the level of the investor.

The ECJ would probably be willing to accept that it was legitimate for EU member states to impose some reporting requirements in the interests of ensuring proper fiscal supervision (and hence indirectly the coherence of its tax
However, it is clear that such requirements have to be reasonable and proportionate as outlined in the Futura case above.

However where the rules applying to foreign funds and their promoters require the complete restating of accounts onto a local taxation or accounting basis then it is unlikely that the ECJ would be willing to accept the wholesale imposition of such detailed and complex requirements, particularly if backed by significant penalties.

EU member states are under an obligation, in designing their tax rules, to take account of the obstacle to cross-border services and investment entailed by the associated compliance requirements. If all EU member states were to adopt the approach of adopting very detailed rules for foreign UCITS sold into their country the ambition of a European single market would be rendered much more difficult as the domestic service provider would have an advantage over foreign providers.

It is also worth noting that EU finance ministers have generally accepted that a relatively low level of reporting should apply in relation to funds that have to report under the Savings Directive. Why, the ECJ might ask, could a similar approach not be acceptable for all UCITS? The Court might also ask how certain EU member states seem to be able to operate quite satisfactorily without such detailed reporting.

### Jurisdictions where onerous administrative burdens apply to foreign UCITS

A number of European countries impose tax reporting burdens on foreign UCITS promoters and their funds. In particular the Austrian, UK, Danish and German governments request foreign fund promoters selling UCITS into their country to undertake local tax reporting obligations on behalf of domestic investors in their products (the Austrian requirements being particularly in relation to ‘whiter than white’ and ‘white’ funds).

If the ECJ were to consider these requirements and conclude that the requirements were not “reasonable and proportionate” following the case law tests above then it is likely that the Court would judge these reporting requirements on foreign UCITS to be in breach of the EU Treaty.

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“EU member states are under an obligation, in designing their tax rules, to take account of the obstacle to cross-border services and investment entailed by the associated compliance requirements.”
Light at the end of the tunnel
Cross-border fund mergers

Why are cross-border fund mergers an issue?
The success in eliminating many of the more serious tax discriminations against cross-border funds outlined in previous sections means that fund managers and sponsors are now beginning to focus attention on whether they can merge some of their existing fund ranges into a more streamlined product offering.

The reasons why fund managers may wish to consider cross-border fund mergers include:

• A reduction in the number of separate UCITS fund ranges can cut costs by reducing overheads associated with running funds such as reduced marketing spend, reduced compliance costs and streamlined fund administration.

• A reduction in the number of products may also permit some streamlining of regulated management companies necessary to act as managers for UCITS funds.

• There could be tax efficiencies for the manager arising from a more streamlined structure, including VAT savings and a reduction in tax compliance costs.

Fund merger mechanics
Directive 90/434 as modified by Directive 2005/19, clearly distinguishes between two processes via which it is possible to achieve fund rationalisation. A ‘transfer of assets’ will typically involve one fund (the “predecessor” fund), without being dissolved, passing its assets to an existing fund (the “successor” fund) in exchange for the issue of securities representing the capital in the predecessor fund. Investors’ shares or units in the predecessor fund may be left in place – but with no value after the transfer – or they may then be cancelled or liquidated. Alternatively a ‘merger’ occurs where, upon being dissolved but without going into liquidation, either:

• one or more funds transfer their assets to another existing fund in exchange for the issue of securities representing their original capital; or,

• two or more funds upon being dissolved but not liquidated transfer all their assets to a fund which they form.

Tax-free domestic mergers permitted but not always extended to cross-border mergers
Most EU member states have introduced some measures to enable domestic fund mergers to take place in a tax-efficient manner so that investors do not suffer tax charges and tax charges at the fund level are also relieved..
No EU member state has specifically enacted tax rules to facilitate cross-border mergers. However in some cases it is possible to utilise the framework for tax-efficient domestic mergers and apply them to cross-border mergers. This would be the case in France and the UK.

Some countries however appear to have rules that permit domestic fund mergers but not those where the successor fund is in another EU member state. Sweden and Germany would be two countries in this category.

This topic is the subject of a further research piece currently being undertaken by PwC which is anticipated to be published later this year. However it is highly likely that countries that permit tax-efficient domestic UCITS mergers but which do not extend this to mergers involving domestic and foreign UCITS would be in breach of Article 56 of the EU Treaty, in that such rules may constitute a restriction on the free movement of capital.

**Regulatory barriers to cross-border mergers**

As well as tax barriers to cross-border mergers, a number of countries appear to put regulatory obstacles in the way of cross-border UCITS mergers whilst permitting domestic UCITS mergers. These will also be analysed in a further research document, but in principle such restrictions would be hard to justify under the EU Treaty.

**The need for European regulation of fund mergers**

Fund managers and sponsors wishing to undertake a cross-border UCITS merger will frequently find that there are significant tax, regulatory and administrative obstacles to such mergers.

While in some cases these obstacles can be surmounted and the merger can take place, even in these cases fund managers and sponsors will generally be seeking to apply domestic rules in a cross-border context with significant risk implications and some uncertainty of treatment.

Given this uncertain environment, the difficulties of persuading all 25 EU member states to be more even handed towards cross-border mergers and the significant benefits that might flow from a more streamlined single funds market there is a strong case for the industry to press the European Commission to bring forward proposals specifically aimed at facilitating cross-border fund mergers.

The advantage of this route is that, once agreed, a fund merger directive would mandate member states to put in place measures to achieve cross-border fund mergers in an efficient manner. Such a new directive could build on the existing Directive referring to this area (Directive 90/434/EU).
Appendix I

Report to the European investment funds industry

Discriminatory tax barriers in the single European investment funds market: a discussion paper
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 – which it is. I was therefore delighted when Steffen Matthias, Pierre Bollon and Sheila Nicoll of FEFSI 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
- 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 Figueireido (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.

David Newton
Partner, PricewaterhouseCoopers, London

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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.
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Disclosure 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 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 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:

![Graph showing growth in foreign registrations of UCITS]

**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” and Member States shall “therefore avoid any overt or covert discrimination on grounds of nationality”.

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3 Case C-279/93, Finanzamt Köln – Alstadt v Schumacker 1995 ECR 1–225 para 21
4 Futura Participations SA and Singer v Administration DES Contributions 1997 ECRI-2471
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:

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<td>Austria</td>
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| Belgium     | i. Tax on distributions to individual investors  
              ii. Participation exemption  
              iii. Benefit from foreign tax credits |
| Denmark     | Foreign Fund legislation                    |
| Finland     | None noted                                  |
| France      | i. Plan d'Epargne en Actions ('PEA')  
              ii. Franchise relief  
              iii. French imputation tax system |
| Germany     | i. Existing foreign investment fund law  
              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  
              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 Directive⁵ 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”.

³ 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” and Member States shall “therefore avoid any overt or covert discrimination on grounds of nationality”.

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.

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6 Case C-279/93, Finanzamt Köln – Alstadt 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 annex 1”.
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:

“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 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
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 Skattermyndigheten i Dalnas, see appendix A for case analysis.

\(^{12}\) Staatssecretaris van Financien 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 Svensson 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, 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. 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.

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\(^\text{18}\) 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.

\(^\text{18}\) 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:

<table>
<thead>
<tr>
<th>Country</th>
<th>Description of discriminatory tax measure*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>Existing income tax regime</td>
</tr>
</tbody>
</table>
| Belgium    | i. Tax on distributions to individual investors  
 |             | ii. Participation exemption                |
 |             | iii. Benefit from foreign tax credits      |
| Denmark    | Foreign Fund legislation                   |
| Finland    | None noted                                 |
| France     | i. Plan d’Epargne en Actions (‘PEA’)        
         | ii. Franchise relief                       |
 |             | iii. French imputation tax system          |
| Germany    | i. Existing foreign investment fund law    |
 |             | 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               |
 |             | 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**


  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\(^\text{19}\) 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.

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\(^{19}\) 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”)**


  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:

<table>
<thead>
<tr>
<th>German Equity Fund</th>
<th>Sondervermögen</th>
<th>UK OEIC UCITS (registered under §17 in Germany)</th>
</tr>
</thead>
<tbody>
<tr>
<td>German dividend income</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Interest income</td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td>Capital gains from investments</td>
<td>20,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Expenses</td>
<td>(900)</td>
<td>(900)</td>
</tr>
<tr>
<td>Tax in fund</td>
<td>(0)</td>
<td>(150)</td>
</tr>
<tr>
<td>Total return</td>
<td>20,300</td>
<td>20,150</td>
</tr>
</tbody>
</table>

**Tax on income**

**German individual investor**

<table>
<thead>
<tr>
<th></th>
<th>German Equity Fund</th>
<th>Sondervermögen</th>
<th>UK OEIC UCITS (registered under §17 in Germany)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income return to investors</td>
<td>300</td>
<td>150</td>
<td></td>
</tr>
<tr>
<td>Taxable return</td>
<td>175&lt;sup&gt;20&lt;/sup&gt;</td>
<td>150</td>
<td></td>
</tr>
<tr>
<td>Tax paid (45%)</td>
<td>79</td>
<td>68</td>
<td></td>
</tr>
<tr>
<td>Net income after all tax</td>
<td>221</td>
<td>82</td>
<td></td>
</tr>
</tbody>
</table>

**German corporate investor**

<table>
<thead>
<tr>
<th></th>
<th>German Equity Fund</th>
<th>Sondervermögen</th>
<th>UK OEIC UCITS (registered under §17 in Germany)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deemed income return</td>
<td>300</td>
<td>150</td>
<td></td>
</tr>
<tr>
<td>Taxable return</td>
<td>50</td>
<td>150</td>
<td></td>
</tr>
<tr>
<td>Tax at 25%</td>
<td>12.5</td>
<td>37.5</td>
<td></td>
</tr>
<tr>
<td>Net income after all tax</td>
<td>287.5</td>
<td>112.5</td>
<td></td>
</tr>
</tbody>
</table>

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.

<sup>20</sup>This is calculated on a look through basis:

<table>
<thead>
<tr>
<th></th>
<th>Total income</th>
<th>Interest</th>
<th>Taxable Dividends*</th>
<th>Dividends</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>1,200</td>
<td>200</td>
<td>500</td>
<td>500</td>
</tr>
<tr>
<td>Expenses</td>
<td>(900)</td>
<td>(150)</td>
<td>(375)</td>
<td>(375)</td>
</tr>
<tr>
<td>Taxable income</td>
<td>175</td>
<td>50</td>
<td>125</td>
<td>125</td>
</tr>
</tbody>
</table>

<sup>*being 50% of dividend</sup>
Tax on gain

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

<table>
<thead>
<tr>
<th></th>
<th>Sondervermögen</th>
<th>UK OEIC UCITS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(registered under §17 in Germany)</td>
<td></td>
</tr>
</tbody>
</table>

**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)
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<sup>23</sup> | 200
Tax paid (45%) | 22.5<sup>24</sup> | 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.

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23. Income 1,200
   Expenses (900)
   Taxable income 300
   Tax at 45% 135
   Tax free dividends 65

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

---

Taxable income 175
Tax at 45% 78.5
Double tax relief (56)
Total tax 22.5

---
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)

<table>
<thead>
<tr>
<th></th>
<th>Sondervermögen (registered under §17 in Germany)</th>
<th>UK OEIC UCITS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>German individual investor</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net capital gain on disposal retained after tax(^{25})</td>
<td>20,000</td>
<td>20,000</td>
</tr>
<tr>
<td><strong>German corporate investor</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net capital gain on disposal before tax</td>
<td>20,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Tax at 25%</td>
<td>0(^{26})</td>
<td>5,000</td>
</tr>
<tr>
<td>Net gain retained after tax</td>
<td>20,000</td>
<td>15,000</td>
</tr>
</tbody>
</table>

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

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\(^{25}\) 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**


  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

<table>
<thead>
<tr>
<th></th>
<th>UK OEIC with UK dividend income</th>
<th>UK OEIC with overseas dividend income</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK Dividend received</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Foreign (e.g. German) dividend received (incl. wht)</td>
<td>(0)</td>
<td>(5)</td>
</tr>
<tr>
<td>UK Corporation Tax in fund</td>
<td>(nil)</td>
<td>(15)</td>
</tr>
<tr>
<td>Distributed returns</td>
<td>100</td>
<td>80</td>
</tr>
</tbody>
</table>

**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.

<table>
<thead>
<tr>
<th></th>
<th>UK UCITS (e.g. UK OEIC)</th>
<th>Foreign UCITS (e.g. Luxembourg SICAV)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend received</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Tax in fund (incl. wht suffered) (nil)</td>
<td>(nil)</td>
<td></td>
</tr>
<tr>
<td>Distributed returns</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

**UK Individual investor:**

- Income received (A): 100
- Tax credit thereon: 10
- Taxable income: 110
- Tax liability (assume higher rate taxpayer): 35.75
- Less: tax credit: (10)
- Tax paid (B): 25.75
- Net income (A-B): 74.25

**UK Corporate investor:**

- Income received: 100
- Tax liability (incl wht): (nil)
- Net income: 100
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.
Appendix II

Discriminatory tax barriers facing the EU funds industry: A progress report
Note from FEFSI and PricewaterhouseCoopers

A report such as this, which covers up-to-the minute developments across the whole of the EU, requires a high degree of collaboration from many people and we are grateful to them for their input to this report.

Firstly our thanks are due to the staff at FEFSI in Brussels, in particular Robert Priester, Senior Legal Adviser, for their enthusiastic support for this project and their help in drafting the report as well as to Wolfgang Mansfeld, the President of FEFSI, and the FEFSI Tax Committee and its Chairman, Pierre Bollon.

We are also grateful to the national fund associations that make up the membership of FEFSI, for reviewing and commenting on our report.

Next, we would like to thank the members of the PricewaterhouseCoopers investment management network around Europe for their help in originating the ideas for this update and for their technical input. This includes: Gerald Schwab and Sylvia Tuczka (Austria), Geert Gemis and Patrice Delacroix (Belgium), Otto Johnsen and Birgitte Tabbert (Denmark), Samuli Makkonen (Finland), Jacques-Hubert Diner (France), Jürgen Kuhn and Steffen Gnutzmann (Germany), Vassilios Vizas and Mary Psylla (Greece), David Lawless (Ireland), Lorenzo Banfi and Francesco Mantegazza (Italy), Laurent de la Mettrie (Luxembourg), Martin Vink (The Netherlands), Jorge Laires (Portugal), Miguel Blasco (Spain), Niclas Soderlund and Staffan Andersson (Sweden), Peter Cussons and Charlotte Worthington (UK).

After the publication of the first report, we received many interesting comments and observations about the report – feel free to keep them coming. You can contact us (and receive further copies of the report) as follows:

**Steffen Matthias** : +32 2 513 39 69 or by email : info@FEFSI.be

**David Newton** : +44 207 804 2069 or by email: david.newton@uk.pwcglobal.com

Finally, we hope that this update serves as a valuable contribution to the development of a true single investment funds market in the EU.

David Newton
Partner, PricewaterhouseCoopers, London

Steffen Matthias
Secretary General, FEFSI, Brussels

January 2003

Cover image: La defense, Paris
1. Introduction

Around eighteen months ago, PricewaterhouseCoopers and FEFSI1 produced a report on the tax barriers encountered by European fund managers doing business around the so-called Single Market.

Two principal conclusions emerged: first, there are significant tax barriers inhibiting the development of a truly Single Market in investment funds, and second, that many, and probably all, of these barriers are legally questionable and could be successfully challenged in the European Court of Justice.

Based on the 2001 Report, FEFSI wrote to the Ministers of Finance of all the Member States where discriminatory measures had been identified, with the aim of drawing the authorities' full attention to the problem and seeking prompt remedial action from the relevant governments. The European Commission was kept fully informed of these bilateral steps.

What has changed eighteen months on? Have the identified barriers been eliminated? Have any new barriers emerged? This report updates last year’s analysis, identifies some new barriers and looks at some additional areas that need to be addressed if the Single Market aspiration for investment funds is to become more of a reality.2

2. Fragmentation and economies of scale in the funds market

The latest statistics show that the US funds market at $7.5 trillion is roughly twice as big as the European funds market at $3.4 trillion. However, as the chart below shows, in Europe the number of funds is actually three times as great as in the US: roughly 26,000 as against 8,000 in the US. This means that the average fund size in Europe is around $136 million compared to the US with $887 million.

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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 association 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 Comments in this paper are correct up to 1 January 2003.
Investment management is a business that responds to economies of scale, meaning that as fund sizes grow larger, the unit cost per Euro or Dollar of assets under management actually decreases. A simple example is a fund manager running a €50m fund. If that fund increased to €100m, there would not necessarily need to be two fund managers. Perhaps more importantly, a larger fund would be expected to have lower transaction costs and custody management charges per unit of assets under management.

Evidence that the retail investment funds industry can benefit from economies of scale is provided by the UK annual PricewaterhouseCoopers survey of the UK fund management industry now in its fourteenth year, which includes detailed cost data for roughly half the UK investment management sector. The survey clearly shows that, over time, management companies which increase the size of their business, are able to benefit from economies of scale in this industry.

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3 "Investment Management Survey 2002 – Pursuing profitability: Heavyweights on the ropes" available from Denise Cook at PricewaterhouseCoopers on +44 20 7212 4952.
So what would happen if the European market average fund size moved in the direction of the US market and a US cost base was applied to the European marketplace?

Estimates and calculations vary, but for an average European fund, charges are around 40 basis points higher than in the US. There are a number of reasons for this, but there is no question that the average fund size is a significant factor in increasing costs to European consumers.

However, many commentators note that there are significant differences between the European and US markets. The largest differences include language barriers in Europe, the historical development of different preferences for savings between individual European countries and also, potentially, a lingering distrust of foreign-branded fund products. Estimates and calculations of the savings that might flow from a single EU investment funds market without tax and other barriers vary, and are difficult to make with any precision. Professor Heinemann and his team concluded that there would be significant savings for consumers from a fully-functioning single investment funds market. Professor Heinemann also concluded that there would be significant cost savings through increasing the average EU investment fund size. As the impact of economies of scale is most dramatic for the smallest funds, Heinemann found that the EU countries with the smallest average fund size would receive the greatest benefit. He and his team estimated that the overall benefit in the EU market, if the average US fund size were to be replicated, would be in the region of €5 billion per annum, though as he states, "there is no reliable way to quantify how these cost savings would be split between the industry (profit margin increase) and the private investors (increase in net returns)".

And taxation remains a significant barrier ...

In our view, the discriminatory tax barriers encountered by fund managers in the EU represent a significant reason for the continued fragmentation of the marketplace and we analyse below the current status of these barriers and steps that can be taken by the European Commission or fund managers to eliminate them.

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4 "The benefits of creating a Real EU Market for Investment Funds" 2002, F. Heinemann – Zentrum für Europäische Wirtschaftsforschung, Mannheim, Tel: +49 621 1235 149.
3. Tax discrimination facing foreign fund distributors

Eighteen months ago, we examined the discriminatory (and legally questionable) tax barriers in the European Union. The table below summarises what has happened in the last 18 months in each country. A detailed explanation follows the table.

Discriminatory measures identified last year have now been completely addressed. Unfortunately, no country has yet eliminated all discriminations.

Some favourable movement has occurred to reduce or eliminate discrimination but significant discrimination still remains.

New discriminatory measures introduced or proposed.

No new discriminatory measures but the status quo persists, which may mean that existing discriminatory measures remain unchanged.

<table>
<thead>
<tr>
<th>Country</th>
<th>Measures identified in the report (as at April 2001)</th>
<th>One year on: what happened?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>Existing income tax regime</td>
<td>(a)</td>
</tr>
<tr>
<td>Belgium</td>
<td>i. Tax on distributions to individual investors</td>
<td></td>
</tr>
<tr>
<td></td>
<td>ii. Participation exemption</td>
<td></td>
</tr>
<tr>
<td></td>
<td>iii. Benefit from foreign tax credits</td>
<td></td>
</tr>
<tr>
<td>Denmark</td>
<td>Foreign Fund legislation</td>
<td></td>
</tr>
<tr>
<td>Finland</td>
<td>None noted</td>
<td></td>
</tr>
<tr>
<td>France</td>
<td>i. Plan d'Epargne en Actions ('PEA')</td>
<td>(b)</td>
</tr>
<tr>
<td></td>
<td>ii. Franchise relief</td>
<td></td>
</tr>
<tr>
<td></td>
<td>iii. French imputation tax system</td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>i. Existing foreign investment fund law</td>
<td>(h)</td>
</tr>
<tr>
<td></td>
<td>ii. New tax reform measures</td>
<td></td>
</tr>
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<td>Greece</td>
<td>Investment funds legislation which penalises foreign UCITS</td>
<td>(c)</td>
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<tr>
<td>Ireland</td>
<td>Taxation of Irish investors in offshore UCITS</td>
<td>(d)</td>
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<td>Italy</td>
<td>Capital gains tax</td>
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<td>Luxembourg</td>
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<td>Netherlands</td>
<td>Reclaim of foreign withholding taxes</td>
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<tr>
<td>Portugal</td>
<td>Different income tax regimes for individual investors</td>
<td></td>
</tr>
<tr>
<td>Spain</td>
<td>None noted</td>
<td>(f)</td>
</tr>
<tr>
<td>Sweden</td>
<td>Fund mergers taxable on investors if a foreign fund is involved</td>
<td>(g)</td>
</tr>
<tr>
<td>UK</td>
<td>i. Offshore fund legislation</td>
<td>(e)</td>
</tr>
<tr>
<td></td>
<td>ii. UK Imputation tax system</td>
<td></td>
</tr>
</tbody>
</table>
Movement on existing discriminatory tax barriers

a) Austria

In our original report, we identified that the income tax law in Austria appears to discriminate against certain foreign UCITS. This is based on two grounds:

(i) All income derived by an Austrian investor from a foreign UCITS is taxed under the income tax scheme with income tax rates up to 50%. The Austrian investor will be deemed to be taxable on his share of income regardless of whether this income, is distributed or not. Income derived by a domestic UCITS from domestic shares, and domestic and foreign debt (including bank deposits), is subject to a 25% withholding tax which is also the final tax. Only income from foreign shares is subject to the income tax scheme with income tax rates up to 50%.

(ii) From 1 January 2001, a "safeguard tax" of 2.5% of the final redemption price at the year end will be applied to investors in foreign funds, unless the holding of the foreign fund is declared to the tax authorities. The "safeguard tax" is treated as a prepayment of income tax.

In relation to the first discrimination (i) above, in March 2002 the Austrian Constitutional Supreme Court decided (C-278/01-7), following a case between an Appellant and the Finance Office of Oberösterreich, that the taxation of holdings of Austrian investors in foreign distributing funds contravenes the Austrian constitution. Interestingly, this case was brought not as an EU Treaty issue but as an issue of parity under the existing Austrian constitution. This decision was reached on the grounds that tax rules introduced in 1993 applied a flat tax rate of 25% only to certain income of domestic investment funds and not to foreign investment funds, although it was the original intention of the income tax law introduced in 1988 to apply the flat tax rate of 25% to foreign funds under certain conditions.

The Court has set a deadline of 31 March 2003 and advised the Austrian government to introduce a tax system that is in line with the Austrian constitution. On 31 March 2003 the existing rules on taxation of foreign distributing investment funds will be repealed. The Court has not provided any detailed indication of what would constitute an appropriate tax system.

There are currently two possible alternatives for the new tax scheme:

The existing system of taxation of domestic investment funds is applied to foreign funds; or

The final 25% withholding tax for domestic investment funds is abolished and domestic investment funds are also brought under the income tax scheme. However, this is seen as the less likely alternative.

This decision has triggered broad discussions and it is hoped that this reform of the tax treatment of Austrian investors in foreign investment funds will also solve any discrimination under EU law.

Even if the tax rates for foreign and domestic investment funds are brought into line the discrimination in the "safeguard regime" remains – see (ii) above.
b) France

In our initial report we highlighted the Plan d'Epargne en Actions ("PEA"), franchise relief and the French imputation tax system as discriminatory measures.

The PEA relief under which French investors may benefit from certain French tax reliefs by investing in a PEA has now been slightly modified. Until 31 December 2001, this tax exemption applied provided the investment was made in predominantly French equities or by a French UCITS, such as an FCP or SICAV, invested in French equities. From 2002, direct investments into all EU Member States' securities will be able to benefit from the relief and, from 2003, the relief will be extended to investments in French UCITS invested in European equities.

However, as foreign UCITS are still excluded from the relief, the most serious discrimination faced by foreign UCITS in France still exists and many providers have established separate French investment fund ranges (and French-regulated subsidiaries) to be able to compete in the French market. This regime effectively means that foreign (non-French) UCITS cannot be widely sold in France, and it therefore contributes to a more fragmented EU UCITS market with lower average fund sizes, the problem outlined in Section 2 above.

c) Greece

A new tax law has recently been ratified in Greece. This includes a provision exempting unitholders of EU-based investment funds from the existing capital gains tax upon redemption of their units. This provision has been drafted on the grounds that the previous discriminatory regime was considered contrary to Articles 49 (freedom to provide services) and 56 (abolition of the restrictions on the movement of capital) of the EU Treaty.

d) Ireland

Ireland changed its offshore funds legislation in 2001. The intention of this was to tax offshore funds located in qualifying locations (including the EU) on a similar basis to Irish funds. Under the revised offshore fund rules, income distributions from a fund located in one of the qualifying jurisdictions received by Irish individual investors are liable to a 2% health contribution levy and, in certain cases, to a 3% social insurance charge. In addition, gains made on disposal (e.g. on redemption) of investments in such offshore funds, may also be liable to the 3% social insurance charge, but not to the 2% health contribution levy. However, neither income distributions from Irish funds nor gains arising from the disposal of investments in Irish funds are liable to such health contribution levy or social insurance charge. There have been indications that Ireland will address this discrimination shortly.

e) United Kingdom

In April 2002, the UK government issued its long-awaited consultation document on the UK offshore funds tax regime. The document confirms the government's commitment to review and, if appropriate, make changes to the current regime to reflect market developments since the original rules were introduced in
1984. The government have confirmed that any legislative changes should be fully compliant with EU law. The UK Inland Revenue asked for comments on a number of questions by 31 July 2002. A further document, summarising responses to this consultation document, was issued in November 2002. It appears likely that new legislation will be enacted in 2004, but until that date, as outlined in the June 2001 report, we believe that the offshore fund legislation is illegal under EU law.

Watchful eye for new measures

Since the last report, FEFSI has continued to keep a vigilant eye not only over the remedial steps on existing cases of tax discrimination, but also over the appearance of new obstacles. Consequently, FEFSI had intervened, in collaboration with the respective national member associations, every time a new problem had been reported and identified, such as in Spain, Sweden and, most recently, in Germany.

f) Spain

Legislation in Spain in force from 1 January 2003, reduces the tax on capital gains (generated over a period of more than one year) from 18% to 15%, and makes the switch from one fund to another tax exempt for capital gains tax purposes for individuals. When the early discussions on this new legislation appeared to install a differentiated treatment between different collective investment institutions, FEFSI forwarded comments to the Spanish government. The industry’s arguments appear to have led the Spanish government and Parliament to adopt an important change in the proposed regime, and (corporate) investment fund vehicles will equally benefit from tax-free switches, provided they have more than 500 investors (or 500 per sub-fund) and no single investor holds more than 5% of the fund (or sub-fund).

g) Sweden

Although there are still no tax barriers for foreign funds in Sweden, new legislation has been introduced imposing new reporting requirements on foreign UCITS in Sweden. However, our view is that this does not appear to constitute a discriminatory measure, as the new rules are similar to existing reporting requirements for domestic UCITS.

However, during the year, another potential case of discrimination has arisen in Sweden in relation to investment fund mergers, which clearly discriminates against Swedish investors in foreign investment funds that merge. Consequently, Swedish tax legislation creates an obstruction to mergers of foreign investment funds. This issue is analysed further in Section 6 below.

FEFSI has made a representation to the Swedish authorities seeking clarification on the interpretation of the provisions in question.

h) Germany

Only very recently, the German government announced proposed changes to the German tax law. The draft bill has yet to pass the Parliamentary process before becoming effective.

The proposed changes include a reform of the tax treatment of German investors in both German and foreign-domiciled investment funds and, if adopted as the text currently stands, will (i) create an unlevel
playing field due to a bias against fund products and (ii) aggravate the existing discrimination of foreign investment funds.

(i) The government proposal sets out the following measures: firstly, in the case of investment funds, a fund must calculate annually the amount of capital gains achieved, which are taxed on the investor at his/her personal income tax rate during the holding period, even if the capital gains have not been disbursed. (With respect to German-domiciled equity funds the "Halbeinkünfteverfahren" applies, or in other words, a half-taxation system whereby only half of the capital gain is taxed). Should the investor decide to redeem at a later stage, then the difference between the original purchase price and the fund’s redemption proceeds will, in a second instance, be struck by a flat rate tax of 15% (7.5% for German domiciled equity funds due to the half-taxation system). To avoid double taxation, the proposed measure foresees that previously annually-taxed capital gains can be deducted from the redemption proceeds of the investment fund's shares. In comparison, direct investment will only be taxed once, i.e. at the point of the realisation of the capital gain at the lower flat rate of 15%, which in the case of equity and the application of the "half-taxation system" will effectively drop to 7.5%. By contrast, proceeds from life insurance will continue to be tax-free after a holding period of 12 years.

(ii) The existing discrimination of foreign funds is aggravated by the fact that for investments in German equity funds only half the capital gain is taxed, whereas the full gain realised by a foreign equity fund will be taxed on a German investor. This "half-taxation system" applies to both taxation charges: both capital gains deemed to arise annually within the fund and also gains realised by the investor at redemption.

FEFSI and a large number of its constituent members have made strong representations to the German government over these proposals, which if unchecked, are proposed to take effect early next year. In addition, in relation to the previous discrimination identified in our June 2001 report, the European Commission has, in December 2002, started the formal process for alleged Treaty infringements against Germany – see Section 5 for further details.

For more detailed information as the Parliamentary debate advances, please contact the authors of this report.

4. Why discrimination is illegal; some developments

Treaty provisions, state aid

In our initial report, we analysed tax measures affecting UCITS that contravene Article 49 (freedom to provide services) or Article 56 (abolition of the restrictions on the movement of capital) of the Treaty. However, as further analysis of the Treaty has been undertaken, and the European Commission has pursued other arguments, there appear to be other provisions of the EU Treaty that may be brought to bear on discrimination against foreign UCITS, in particular under the "state aid" provisions.

Article 87 requires that "any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the
production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market. Besides direct payments to companies, state aid also covers interest rebates on credits, tax reliefs or special tariffs. In July 2001, the Commission announced that it would, in fact, use the state aid provisions to challenge taxation measures in member states.

It is the Commission's duty to monitor all systems of aid existing in Member States. The Commission has the right to decide that the Member State concerned shall abolish or alter any aid it has identified as non-compatible with the Single Market by a fixed date. If the Member State does not comply with this decision within the prescribed time, the Commission is entitled to refer the matter directly to the European Court of Justice.

We believe that a number of the discriminations identified by the June 2001 report and the analysis above are capable of being remedied under the Commission's state aid powers.

**European Court of Justice - Developments**

In October 2002, the European Court of Justice (ECJ) ruled in favour of the applicant in the Danner case that concerns the compatibility of certain Finnish tax law provisions with the freedom to provide services. The case concerned Rolf Dieter Danner, a dual citizen of Finland and Germany. Dr Danner had previously worked in Germany where he made contributions to two local pension schemes. Following a subsequent move to Finland, he continued to maintain contributions to the German schemes. However, the Finnish tax provisions preclude or restrict the deductibility for income tax purposes of voluntary pension insurance contributions paid to foreign insurance institutions. The case concerned whether these tax provisions are contrary to the EC Treaty.

The need to preserve coherence of the Finnish tax system was put forward by Finland as one of the grounds for justifying a measure restricting freedom to provide services as in Bachmann and Commission v Belgium. The ECJ, however, concluded that the Finnish Government cannot invoke the need to preserve fiscal coherence as there is no direct link between the deduction of contributions and the taxation of pensions, and by signing a double taxation agreement with the German government giving the right to tax pensions in this case to Germany, fiscal coherence had already been compromised.

This case has further clarified the legal challenges that can be mounted against tax discriminations and also the extent of the fiscal coherence defence in current European judicial thinking. However, the ruling fails to extend significantly the points of law previously established from the Wielockx case, and in this respect, the judgement is disappointing.

**5. Initiatives by the Commission**

In May 2001, the Commission issued a Communication on tax policy with the key message that the Commission saw no need for across-the-board harmonisation of Member States' tax systems, except in the area of indirect tax, where a high degree of harmonisation is essential. It was acknowledged that the smooth functioning of the Internal Market is a priority and is committed to continuing to fight against harmful tax competition and discrimination in the EU tax system that impedes the development of the Single Market.

5 Rolf Dieter Danner v Finnish State C-136/00
6 Bachmann v Belgian State Case C-204/90
7 *Tax policy in the European Union: Priorities for the years ahead* – Com (2001) 260
In relation to discrimination, the Commission says that it cannot, “as guardian of the Treaty”, be lenient on infringements in the tax field, but the question remains whether the actions and policies by the Commission reflect a proper attention to Treaty infringements, and indeed, whether more time should be spent on pursuing treaty infringements rather than trying to develop new direct policy initiatives on which it is notoriously difficult to reach unanimous agreement (as required by the Treaty).

In December 2002, the Commission announced that it is launching the first stage of infringement proceedings against Germany over the discriminations identified in our last report. This is a welcome step towards addressing and seeking to remove these provisions. However, while this is a welcome development, it is disappointing that the Commission has not started infringement proceedings in relation to the other blatant tax discriminations identified in our June 2001 report. Unfortunately, until such action is taken by the Commission (or fund managers), countries are unlikely to take their treaty obligations seriously. Our conclusion, therefore, is that there is much for the Commission to do in this area.

6. Looking ahead – some areas for further attention

If the single market in EU investment funds is to be achieved, there are two further areas of discrimination that should be drawn to the European Fund industry’s attention. These are in the area of double tax treaty negotiation including investor credit for foreign tax and investment fund mergers. These are dealt with briefly below.

Double tax treaties and investor tax credits

Most EU investment funds are not able to benefit from double taxation treaties. The impact of this is that, generally, the EU mutual fund will suffer a higher rate of foreign withholding taxation on its income than the typical investor in an EU country investing directly. Furthermore, in many cases an investor in an EU fund domiciled outside his or her home state will not receive any credit for withholding taxes suffered by the fund. The combined effect of these inefficiencies could add up to around 0.6% of asset values to the investor costs in a typical equity-based mutual fund.

The solution to these problems is twofold:

Firstly, EU Member States should be encouraged to negotiate treaties that recognise the single market aspiration. Ideally, this would enable EU mutual funds to obtain treaty benefits, provided that most or all of the investors were resident in the EU.

The Commission has until now left this as a mainly bilateral matter for individual EU states to address, which has led to highly unsatisfactory results. For example, the UK/US treaty that is currently in the process of ratification clearly does not respect the single market aspiration because it denies treaty benefits to UK UCITS invested in the US if too many EU continental investors hold shares in the investment fund.

The second solution relates to the loss of tax credit to investors investing in a foreign UCITS. This requires agreement on an EU level that any withholding taxes suffered by any EU investor in a mutual fund will be allowed to flow through as a credit (i.e. offset) against his or her domestic tax liabilities.
The first issue, double tax treaty negotiations, has been discussed at the European tax conference "Towards an Internal Market without corporate tax obstacles" held in Brussels on 29 and 30 April 2002, where it was concluded that work should commence in 2003 on the preparation of a Communication on double tax treaties in the light of the EU Treaty principles.\(^8\)

However, this issue could be affected by the recent ruling of the European Court of Justice on the legality of the bilateral "open skies" air transport agreements concluded by individual Member States with the US.\(^9\) In November 2002, the Court ruled that even if no EU legislation has been passed in the area, Member States must exercise their powers to conclude bilateral agreements consistently with Community law, i.e. to prevent advantages arising to their nationals in comparison to nationals of other Member States who have exercised their right to freedom of establishment. It may well be that treaties such as that recently concluded between the US and the UK are illegal, because UK funds with continental investors can be denied treaty benefits.

**Merger of funds**

Finally, we want to focus attention on what happens if two investment funds are merged that are resident in different EU Member States. Such mergers would appear to be essential if the EU Single Market in investment funds is to be achieved, with the resulting economies of scale. For example, in the diagram below, if the fund manager wishes to merge these two funds will the investors or the funds suffer a tax penalty? Unfortunately, the answer in many cases may be that there is a tax charge.

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\(^8\) "Towards an Internal Market without corporate tax obstacles" 29 and 30 April 2002. (http://europa.eu.int/comm/taxation-customers/taxation/company-tax/conference.htm)

\(^9\) Commission v United Kingdom, Denmark, Sweden, Finland, Belgium, Luxembourg, Austria, Germany: C-466/98, C-467/98, C-468/98, C-469/98, C-471/98, C-472/98, C-475/98 and C-476/98.
Looking across the EU, two distinct treatments can be identified:

First, a merger qualifies as a tax free share for share exchange, no matter if it concerns the merger of two domestic UCITS or a domestic and a foreign UCITS. This treatment applies, for example, in the UK (except possibly stamp duty at 0.5%), Austria and France. In Spain and the Netherlands there appears to be no discrimination from a tax perspective, however, no legal framework is in place for such a merger.

Second, a merger between a domestic and foreign UCITS constitutes a taxable event, giving rise to a tax charge at the investor level, whereas the merger between two domestic UCITS is tax free. This is the case for Sweden, Denmark, Greece, Italy and Finland.

The possibility of merging EU UCITS tax free both at the fund level and the investor level is an important issue that merits attention from the industry and the Commission. This could make a significant difference to the structure of the EU fund industry over the next ten years and enable it to realise some of the economies of scale referred to earlier. It would also have some parallels with the corporate merger directive which is currently an area being looked at by the Commission. However, if the investment funds industry fails to make its voice heard over this issue, then it may well be overlooked in these discussions.

7. Overall Conclusion

In overall terms, not much progress has been made over the last year-and-a-half to eliminate discriminatory EU taxation barriers facing foreign UCITS. Significant barriers still exist in France, Germany and the UK (among the largest EU markets) and recent developments in Germany, if enacted, will further increase discrimination against foreign funds.

While there are signs that the Commission is working "behind the scenes" to get these barriers dismantled, there is little concrete progress and so the picture one-and-a-half years after our first report is a disappointing one. Only one formal treaty infringement procedure (against Germany) has been started by the Commission (in December 2002 – see Section 5) which prompts the question: why have the other countries identified in the June 2001 report escaped similar action?

For the funds industry, it would be possible to make progress independently. However, this requires the industry to be as prepared as the insurance industry to take discrimination cases where its interests are adversely affected.

Looking further ahead, the industry and the European Commission should, in our view, be considering how EU double tax treaties and tax credit systems could be made less costly for investors and how EU investment fund mergers could be made a tax-free event. Without these changes it is hard to see how the true Single Market with all its potential benefits to consumers can be achieved.
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