Tax Exemption of Foreign Investment Funds – Finnish Perspective on Advocate General Pitruzzella's Opinion in ECJ C-156/17 (Köln-Aktiefonds Deka)

Kluwer International Tax Blog
September 27, 2019

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Please refer to this post as: Heikki Vesikansa, 'Tax Exemption of Foreign Investment Funds – Finnish Perspective on Advocate General Pitruzzella's Opinion in ECJ C-156/17 (Köln-Aktiefonds Deka)', Kluwer International Tax Blog, September 27 2019, http://kluwertaxblog.com/2019/09/27/tax-exemption-of-foreign-investment-funds-finnish-perspective-on-advocate-general-pitruzzellas-opinion-in-ecj-c-156-17-koln-aktiefonds-deka/

In many member states' tax law, mutual investment funds are relieved from double taxation, i.e. proceeds from investments are taxed only once even though they are earned on two levels: first at the level of the fund, and then at the level of the owners of the fund. The logic behind this is that mutual investment activity should not be burdened with double taxes compared to direct investments.

Member states employ different techniques for this relief. Most often, the relief is achieved by granting the investment fund a tax exemption and taxing the proceeds when they are distributed to the owners. Member states may freely set the preconditions for the tax exemption in their national tax laws, i.e. they are free to determine which kinds of investment funds enjoy the relief from double taxation. However, member states cannot use their tax laws to hinder free movement of capital and free movement of (asset management) services, which are protected by the EU's basic treaties. Hence, member states must grant similar tax benefits to investment funds residing in other member states when such foreign funds are objectively comparable to domestic tax-exempt funds.

ECJ C-156/17 – AG Pitruzella's opinion

In *Köln-Aktiefonds Deka* (KA Deka), the court investigates a situation where a German contract-based fund without legal personality (*Sondervermögen*) has made investments into Dutch shares. In Germany, the fund KA Deka is tax exempt and investment proceeds are only taxed at the level of its owners. In the Netherlands, investment funds enjoy a 0% tax rate (sc. FII regime) if they meet, among other things, the following two conditions: (1) they distribute 100% of their operational profits to owners within 8 months from the end of the fiscal year, and (2) they meet certain requirements relating to the owners of the fund – i.e., the owners must consist mainly of natural persons or pension funds and the ownership may not be excessively concentrated to one individual. The requirements relating to the owners are less strict if the fund participations are listed on the Amsterdam Stock Exchange. Dutch FII's can have several different legal forms, such as limited liability company, public limited liability company, or a contract-based fund.

KA Deka had claimed a refund of withholding taxes paid on dividends received from its Dutch investments. The basis of the claim was that Dutch FII's are also exempt from Dutch tax in relation to the received dividends. The Dutch tax authorities had rejected KA Deka's claims essentially on two grounds: (1) participations in KA Deka were traded anonymously in a "global stream system", and hence KA Deka could not provide proof that it met the Dutch FII regime's requirements relating to the owners of the fund, and (2) under German law, KA Deka was not under a mandatory obligation to distribute 100% of its operational profits to its owners within 8 months from the end of the fiscal year.

According to AG Pitruzzella's opinion issued on 5 September 2019, as a starting point, taxes imposed on cross-border investments can obstruct the free movement of capital in a way that can be considered a violation of EU treaties. This is the consequence of applying different tax treatment to situations that are objectively similar, and this will lead to foreign investors being less inclined to make investments into the member state imposing such taxes on them. In this context, AG Pitruzzella concludes that member states are not allowed to set requirements for preferential tax regimes that are impossible or disproportionally difficult for foreign funds to satisfy.

Furthermore, AG Pitruzzella states in relation to the Dutch tax authorities' **first grounds** for rejection that, as such, the requirements relating to the owners of the fund are understandable and aim to prevent abuse of the FII regime. Therefore, the fact that the "global stream system" cannot provide this information falls to the responsibility of the tax payer and it is not, as such, a violation of the free movement of capital to require this information from KA Deka. However, AG Pitruzzella expresses his confusion towards the fact that the FIIs enjoy less strict requirements relating to the owners of the fund if the FII participations are traded on the Amsterdam Stock Exchange. AG Pitruzzella remarks that the Dutch court which had referred the case to the ECJ should specifically investigate whether FIIs listed on the Amsterdam Stock Exchange are predominantly also resident in the Netherlands, which could imply that the requirements applied to domestic investment funds are in fact more beneficial and could thus lead to the factual discrimination of foreign funds.

As regards the Dutch tax authorities' **second grounds** for rejection, AG Pitruzzella states that KA Deka has demonstrated that – even though under German laws it is not required to distribute its operational profits annually – German laws provide for a different technique, which essentially has the same aim. In fact, under German laws, a fictional income is taxed at the level of the owners of KA Deka despite the amount of distributions paid by KA Deka. AG Pitruzzella concludes that member states cannot require foreign funds to meet completely similar requirements as domestic funds in order to enjoy the relief and, in the case of KA Deka, a violation of the free movement of capital would follow if it was impossible or disproportionately difficult for KA Deka to meet the requirement of mandatory distributions when – at the same time – the German tax system provides for the fictional inclusion of such profits in KA Deka's owners' taxable income.

Finnish reflections

As of 2019, Finland has enacted provisions in the Income Tax Act on the recognition of foreign tax-exempt funds. According to the main rule, domestic and foreign investment funds are tax-exempt if they are contract-based (without legal personality), open-ended, and have at least 30 owners. If the investment fund has less than 30 owners or it is closed-ended, there are additional requirements, such as an annual mandatory distribution of 75% of its operational profits. If the investment fund invests predominantly into real estate, the fund must always distribute 75% of its operational profits annually in order to be tax-exempt.

In March 2019, the Finnish Supreme Administrative Court (SAC) issued a decision regarding the recognition of a Dutch FII, which had invested predominantly into real estate. The SAC did not refer the case to the ECJ and decided that a Dutch FII could not be recognised as tax-exempt in Finland, because its legal form was a public limited liability company (N.V., *naamloze vennootschap*), and in Finland investment funds are considered tax-exempt only if they are contract-based (without legal personality). In its reasoning, the SAC did not specifically address the tax payer's claim that *factually* the Finnish resident investment funds that invest into the same category of assets as the Dutch FII had – except for one – chosen to be contract-based (without legal personality).

In June 2019, the Finnish Supreme Administrative Court made a referral to the ECJ in another case concerning a Luxembourgian SICAV fund. The fund in question is open-ended and tax-exempt in Luxembourg , and it distributes its annual earnings to its owners. However, the fund's legal form is a limited liability company. The Finnish Tax Administration had decided to tax the distributions made by this SICAV fund to its Finnish owners as earned income (subject to rates up to ~55%) instead of capital income (subject to rates up to 34%). In contrast, distributions made by domestic contract-based funds (without legal personality) are taxed with the capital income rates. The SAC is now seeking a preliminary ruling from the ECJ as to whether or not Finland can apply these higher rates to the Luxembourgian SICAV's distributions based on the fact that the legal entity form of the SICAV is a limited liability company and not a contract-based fund.

Conclusions

If the ECJ will decide *KA Deka* along the lines of AG Pitruzzella's opinion, then it would seem that Finland's requirement relating to the minimum number of owners in a fund would not be disproportionate under EU laws, and foreign funds would need to demonstrate that they meet this requirement from tax year 2020 onwards.

The requirement relating to the mandatory distribution of profits is, in principle, not disproportionate. However, if the tax systems in other member states have equivalent techniques to meet the same targets – such as the techniques in the German system – the Finnish requirements could be disproportionate and violate the EU law.

AG Pitruzzella's opinion emphasises that the determination of barriers to free movement is not only a norm-based but also a fact-based analysis. Although requirements for relief can be formally equal for domestic and foreign funds, their application cannot lead to factual discrimination of foreign funds. The determination of factual discrimination is a matter to be investigated by the national courts, and the ECJ is vigilant in monitoring that this investigation takes place.

Another interesting topic relating to the Finnish rules on the recognition of foreign tax-exempt funds is the proportionality of the legal form requirement, i.e. that categorically only contract-based funds can be tax-exempt. The ECJ will undoubtedly shed more light into this aspect when it issues its preliminary ruling on the case concerning the Finnish taxation of distributions made by the Luxembourgian limited liability company SICAV.