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TAX TREATMENT OF INVESTMENT FUNDS AND THEIR INVESTORS WITHIN THE EUROPEAN UNION

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Tomi Viitala
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ABBREVIATIONS

Afg-Asffi	*Association française de la gestion financière – Association française des fonds et des sociétés d'investissement et de gestion d'actifs financiers* (Association of the French Fund Industry)
ALFI	*Association Luxembourgeoise des Fonds d'Investissement* (Association of the Luxembourg Fund Industry)
AuslInvestmG	*Gesetz über den Vertrieb ausländischer Investmentanteile und über die Besteuerung der Erträge aus ausländischen Investmentanteilen* (repealed) (Germany)
AUT	Authorised unit trust (UK)
BAFin	*Bundesanstalt für Finanzdienstleistungsaufsicht* (Financial Services Supervisory Authority, Germany)
BMF	*Bundesministerium der Finanzen* (Ministry of Finance, Germany)
BVI	*Bundesverband Deutscher Investment-Gesellschaften e.V.* (Association of the German Fund Industry)
CFC	Controlled foreign company
CGI	*Code général des impôts* (General Tax Code, France)
CIS	Collective Investment Schemes Sourcebook (UK)
CSSF	*Commission de Surveillance du Secteur Financier* (Financial Services Supervisory Commission, Luxembourg)
EC	European Community
ECJ	Court of Justice of the European Communities
ECR	Reports of cases before the Court
EMU	European Monetary Union
EStG	*Einkommensteuergesetz* (Income Tax Act, Germany)
EU	European Union
FCP	*Fonds commun de placement* (Luxembourg, France)
FEFSI	*Fédération Européenne des Fonds et Sociétés d'Investissement* (Association of the European Fund Industry)
FG	*Finanzgericht* (Tax Court, Germany)
FIN	Finland

FRA	France
FSA	Financial Services Authority (UK)
FSMA 2000	Financial Services and Markets Act 2000 (UK)
GER	Germany
HE	*Hallituksen esitys* (Government Bill, Finland)
IBFD	International Bureau of Fiscal Documentation
IFA	International Fiscal Association
IML	Institut Monétaire Luxembourgeois (replaced by CSSF)
InvStG	*Investmentsteuergesetz* (Investment Tax Act, Germany)
IR	Inland Revenue (UK)
IRS	Internal Revenue Service (US)
KAGG	*Gesetz über Kapitalanlagegesellschaften* (repealed) (GER)
KapSt	*Kapitalertragsteuer* (Withholding tax on capital income, Germany)
KHO	*Korkein hallinto-oikeus* (Supreme Administrative Court, Finland)
KVL	K*eskusverolautakunta* (Central Tax Board, Finland)
LUX	Luxembourg
LähdVA	*Asetus rajoitetusti verovelvollisen tulon ja varallisuuden verottamisesta* 30.12.1996/1305 (Decree on Taxation of Income and Wealth of a Person with Limited Tax Liability, Finland)
LähdVL	*Laki rajoitetusti verovelvollisen tulon ja varallisuuden verottamisesta* 11.8.1978/627 (Act on Taxation of Income and Wealth of a Person with Limited Tax Liability, Finland)
MenetelmäL	*Laki kansainvälisen kaksinkertaisen verotuksen poistamisesta* 18.12.1995/1552 (Act on Elimination of International Double Taxation, Finland)
OECD	Organization for Economic Co-operation and Development
OEIC	Open-end investment company (UK)
OJ	Official Journal of the European Communities
OY	*Osakeyhtiö* (Company limited by shares, Finland)
OYL	*Osakeyhtiölaki* 29.9.1978/734 (Companies Act, Finland)
RATA	*Rahoitustarkastus* (Financial Supervisory Authority, Finland)

RIC	Regulated Investment Company (US)
RÅ	*Regeringsrättens Årsbok* (Decision of the Supreme Administrative Court, Sweden)
SICAV	*Société d'investissement à capital variable* (LUX, FRA)
SijRL	*Sijoitusrahastolaki* 29.1.1999/48 (Act on Investment Funds, Finland)
TVL	*Tuloverolaki* 30.12.1992/1535 (Income Tax Act, Finland)
UCI	Undertaking for collective investment
UCITS	Undertaking for collective investment in transferable securities
UK	The United Kingdom
UKEP	UK equivalent profits
US	The United States of America
VCLT	Vienna Convention on the Law of Treaties
VM	*Valtiovarainministeriö* (Ministy of Finance, Finland)
VVL	*Varallisuusverolaki* (Net Wealth Taxation Act, Finland)
YHL	*Laki yhtiöveron hyvityksestä* 29.12.1988/1232 (Act on Imputation Credit, Finland)
ZASt	*Zinsabschlagsteuer* (Withholding tax on interest, Germany)

1 INTRODUCTION

1.1 Subject of the Study

Institutional investors have emerged as dominant holders of financial assets and increasingly as important participants in capital markets.[1] Of the types of institutional investors, the growth of financial assets under management has been the highest for investment companies and investment funds, with an annual rate of 15 per cent.[2] The appeal of investment funds as a means of investment may be explained by the fact that they provide individual investors with an efficient means of holding a well-diversified and professionally-managed portfolio of securities. Through investment funds individual investors are able to participate in various companies and market places worldwide without the need for sophisticated knowledge of individual companies and markets.

The expansion of the investment fund industry has also been one of the most notable trends of recent decades on the financial markets throughout the European Union. Assets in investment funds grew from 1 trillion euro to over 4 trillion euro from 1992 to 2002. This means that assets in European investment funds grew at an average compound annual rate of 15,9 percent over the last ten years.[3] In some states with an under-developed investment fund industry the growth was even more impressive. Remarkably, in Finland, the assets under management in investment funds grew as much as fiftyfold.[4]

The increased importance of investment funds as a means of investment within the European Union has been compounded by legislative, demographical and economic factors. Firstly, the UCITS Directive[5] of 1985

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[1] OECD (2003b) 9.

[2] See OECD (2003b) 15. For the purposes of the OECD statistics, the notion of investment companies includes both open-end and closed-end investment institutions. The terminology is not consistent but the former are often referred to as investment funds, whereas the latter are often called investment companies. For the definitions of an open-end investment fund and a closed-end investment company, see discussion in Chapter 2.14. Other important types of institutional investors include insurance companies and pension funds. See OECD (2003b) 304.

[3] FEFSI Fact Book 2003, 7. The number includes also some of the new Member States.

[4] See FEFSI (2001).

[5] Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities. OJ L 375, 31/12/1985 p. 3-18. The UCITS Directive covers only publicly-offered open-end investment funds which invest in transferable securities and money market instruments.

has laid down common standards for investor protection in the Member States of the European Union, thereby enhancing investor confidence in investment funds. The UCITS Directive has also facilitated an easier cross-border distribution of investment funds in the Member States. Secondly, in recent years the pressure towards private pension schemes has steadily increased due to ageing populations in the Member States of the European Union. When governments are calling for new ways of financing future pensions instead of sole reliance on public pension systems, investment funds are often mentioned as one of the serious alternatives for the arrangement of pension schemes. Finally, the long-standing rise in the stock markets in the second half of the 1990s certainly had a strong impact on the investment behavior of many households by encouraging these to improve the performance of their savings through investment funds.[6]

Along with the growth of the investment fund industry, there has been an increasing interest in cross-border transactions within the European Union. This has been assisted by the increased awareness of the benefits, in the form of a better risk-return relationship, for investments brought about by international diversification of assets. Therefore, one of the biggest challenges for the European Union is considered to be the building of a single financial market comprising a single financial services market and a single capital market.[7] The consequences of realizing the objective of an integrated European financial market are described as follows:

> "[T]he supply of European capital from European savings will be efficiently matched with the demand for capital from European businesses. Consumers will be better able to purchase financial services and securities from the best European suppliers of investment, insurance and pension funds, with net yields increasing as investment choice widens."[8]

As investment funds are important financial intermediaries and suppliers of capital within the European Union, the aim of establishing a single market for them is one of the priorities when building an integrated financial market. In a single market, an investment fund established in a Member State must be able to compete for European investors, whether residents or non-residents of the same Member State, on a level playing field with other investment funds, whether established in the same or other Member States. In a single market, an investment fund must also be able to invest its assets in securities, whether traded on capital markets of the same Member State or other Member States.

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[6] See FEFSI Fact Book 2003, 12-13 and 37-38.
[7] Lamfalussy Report (initial) 72.
[8] Lamfalussy Report, 9. For more discussion on economic benefits of creating a single market for investment funds, see Heinemann (2002) 5-9.

Moreover, in a single market, a prospective fund investor of a Member State must be able to choose freely between investment funds, whether established in the same Member State or other Member States. These being the features of a single market for investment funds, it is fair to say that the objective is yet to be realized.

Indeed, the market for investment funds is still characterized by a continuing relevance of national borders.[9] According to some estimates, only some 3 500 investment funds, representing roughly 20 per cent of all investment funds within the EU, are being distributed across the borders of Member States. Of these, only approximately 1 000 investment funds are registered for public sale in six or more Member States.[10] Many national fund promoters do practically not market their funds cross-border. Consequently, a vast majority of the funds marketed cross-border is established in a single jurisdiction, namely Luxembourg. In no EU Member State there are at present investment funds available from more than six other Member States. Apart from the data on cross-border notifications, there are no data on the market success of foreign investment funds on a consistent basis.[11]

One of the most influential constraints on a single market is the differences between tax treatments across the Member States.[12] Generally speaking, it is a well-known fact that taxes influence the movement of mobile capital and, therefore, investment decisions by individuals as well as any other economic actors.[13] Within the European Union, the importance of taxes as a factor influencing economic decisions has generally increased, along with the abolition of exchange controls and the standardization of financial regulations between the Member States.[14]

1.2 Objective and Scope of the Study

The purpose of this study is to examine the tax treatment of investment funds and their investors within the European Union. In doing this, the study divides into two separate parts, in terms of the viewpoint taken. First, the tax treatment of investment funds and their investors under the current tax laws and tax treaties of the Member States will be examined ('Member State level'). Second, the impact of the integration process of the European Union on

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[9] See Heinemann (2002) 2.
[10] See Lipper Analytical Services; Heinemann et al. (2003) 33.
[11] See Heinemann (2002) 3.
[12] See Heinemann et al. (2003) 49; FEFSI Fact Book 2003, 8.
[13] To that effect, see, for example, Mutén (1994).
[14] See Chown (2000) 103.

national tax legislations governing investment funds and their investors will be examined, in light of the object of establishing a single market for investment funds ('Community level').

As regards the taxation of investment funds and their investors at the *Member State level*, the study distinguishes between three categories of taxing events:

1. Taxation of the investment fund in the residence state;
2. Taxation of investment made by the investment fund in the source state of income
   - 2a) when the investment fund is resident;
   - 2b) when the investment fund is non-resident;
3. Taxation of the fund investor from the perspective of a Member State,
   - 3a) when the resident investor invests in a domestic investment fund;
   - 3b) when the resident investor invests in a foreign investment fund;
   - 3c) when the non-resident investor invests in a domestic fund.[15]

In addition to substantive tax laws, the study also deals with the enforcement of tax laws in the context of investment fund investments.

As regards the taxation issues arising at the Community level, the study distinguishes between:

1. Negative integration, dealing with the impact of primary Community law on the taxation of investment fund investments;
2. Positive integration, dealing with the impact of secondary Community law on the taxation of investment fund investments.

The objective of the study is to provide a comprehensive understanding of the issues related to the tax treatment of investment funds and their investors within the European Union. To date, studies dealing with the taxation of investment funds and their investors have restricted themselves to a single issue, or at least to a limited number of issues, thereby having failed to address the issue from a broader point of view. In the author's opinion, it is of the utmost importance to understand the interconnection of different taxing events when dealing with the taxation of investment funds and their investors. In a cross-border context, the outcome may turn out rather differently depending on whether the focus is on only one taxing event[16] or on all relevant and

[15] The examination of the taxing events 1) and 3) is made on a state-by-state basis. However, the taxing event 2) follows a more general approach. This is owing to the fact that investment funds covered by this study, as a rule, hold in their portfolio a mix of securities from several countries without restricting their investments in the countries where they are established, or marketed.

[16] For example, taxation in the source state of income.

interdependent taxing events[17]. By the same token, it is equally important to take into account not only substantive tax rules but also the enforcement of such rules in practice.[18] A comprehensive understanding is also, in the author's view, the prerequisite for any adequete addressing of the issues raised by the taxation of investment fund investments at the Community level.

On the other hand, it is obvious that, in view of the range and ambiguity of issues related to the subject under study, to a certain extent a trade-off between comprehensiveness and thoroughness must be made within the limits of one study. In this study, it is made in favor of the former. The disadvantage of the chosen approach is that the examination cannot be completed with regard to each and every possible detail of the matter. In this respect, this study aims to take a pragmatic approach, in that the discussion will not extend far beyond the limits set by practical constraints. In fact, practical constraints, whether on the side of tax authorities or taxpayers, should not be neglected in studies of tax law.[19] The requirement for efficiency in taxation restricts, to a certain extent, the possible interpretations and applications of tax rules.[20]

In view of the significant number of issues to be covered, careful restriction of the scope of the study is of great importance. This study considers the taxation of underlying investors of investment funds to the extent that they are individuals. In the first place, this is justified by the fact that households generally constitute the most significant category of underlying investors in the investment funds covered by this study. In particular, this holds true with respect to equity funds which not only traditionally have been the most popular type of fund[21], but which also have been the context for the most interesting taxation issues. Generally speaking, the statistics usually give a somewhat distorted view of the significance of households as fund investors, because in most cases there is – behind the figures representing the ownership by the category of insurance companies – hidden ownership by households acting as pension or life assurance policyholders.[22] However, in this study

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[17] For example, taxation in the source state of income and in the residence state of the investor.
[18] In particular, this is important in an international context, because many of the issues arising are related to possibilities of enforcing tax laws in practice. See Vapaavuori (1991) 7.
[19] For the importance of practical matters in the field of tax law, see Tikka (1972) 69-73.
[20] See Tikka (1972) 87.
[21] Within the European Union, 31 per cent of UCITS were equity funds, 32 per cent bond funds, 21 per cent money market funds, 14 per cent balanced funds and 2 per cent other funds. See FEFSI (2003). It must also be mentioned that the relative proportion of equity funds varies significantly depending on the performance of stock markets, whereas the popularity of bond funds is more stable. The popularity of money market funds depends often reversibly on the success of equity funds. This is explained by the fact that the money market funds often serve as a 'parking place' for money not invested in stock markets when times are bad.
[22] The information is based on an interview given by Markku Savikko, the CEO of *Sijoitusrahastoyhdistys* (the Finnish Mutual Funds Association) at *Arvopaperi* Online (http://www.arvopaperi.fi) on 3.5.2001.

only individual investors holding units in the investment fund directly without other intermediaries are considered. Consequently, investors participating indirectly in the investment fund on the basis of pension or life assurance arrangements through insurance companies are not considered.[23] Furthermore, attention will not be paid to pension or other savings schemes which entail special rules concerning the tax deductibility of contributions paid to or tax liability for income received within such schemes by investors.[24] It is also presumed for the purposes of this study that the income derived by the individual investor is not classified as professional or business income but is taxed in accordance with the rules applied to income derived in the course of a non-business or non-professional savings or portfolio investment activity.[25]

It also follows that the taxation of companies or tax-exempt institutions as fund investors will not be covered by this study. This can, in the first place, be justified by the relatively lower significance of companies and tax-exempt institutions, as compared with private investors, as participants in the funds covered by this study, though this may vary depending on the country and fund type in question.[26] As regards companies, it may be also argued that behind companies there are eventually shareholders which are often households. However, taking corporate investors into consideration would add another tax subject to the chain between the individual investor and the investment fund, thereby adding significantly to the complexity of the study.

Owing to the many possible variables resulting from the number of Member States of the EU, as well as from the taxing events to be considered, not all the Member States can be covered to keep the material under study manageable.[27] Therefore, the study is generally restricted to five selected Member States. However, references to, or comparisons with, non-selected Member States will also be made, when appropriate. The primary criterion for selecting the Member States to be covered has been their economic

[23] In such a case, the insurance company generally is the legal owner of the assets invested in an investment fund. It follows that the taxing issues related to such indirect fund investments may differ from those related to direct fund investments.

[24] An example of such a scheme is the individual savings account (ISA) in the United Kingdom. The return on investments in an ISA is tax exempt. See European Tax Handbook 2003, 688.

[25] Often the tax rules applicable differ, depending on whether the activity is classified as business or private activity.

[26] For example, in Finland non-households held some 71 per cent of the units in Finnish investment funds. See RATA (2003). However, the relatively high proportion is partly explained by the fact that money market funds are likely to be mainly owned by institutional investors and corporations.

[27] Another approach would have been to consider the taxing problems in the area of investment fund investments at a more general level, in contrast to the country-by-country approach adopted in this study. However, due to the complexity of taxing problems in the area of investment fund investments, it was considered preferable to include a limited number of involved Member States. A country-by-country approach allows for a more thorough examination of taxing problems arising in cross-border investment fund investments between the selected Member States. However, in order to ensure a more rigorous examination, the number of selected Member States must of course be limited.

importance in terms of the size of the market area for investment funds, or of the volume of assets under management in investment funds established in the jurisdiction. The Member States included on the basis of both the size of the market area and the amount of managed assets are Germany, France and the United Kingdom. In practice, each of them not only has a well-established domestic investment fund industry, but also attracts a large number of foreign investment funds from other Member States to market their units cross-border, due to the high number of prospective investors. The Member State chosen solely on the basis of its importance as a state in which investment funds are established is Luxembourg. It not only accounts for 23 per cent of European investment funds in terms of assets under management but also for some 80 per cent of the investment funds marketed across the borders[28]. In line with their importance, Luxembourg investment funds are also used as the main example when considering the taxation in other Member States of foreign investment funds and income from foreign investment funds. Conversely, the taxation of Luxembourg investors will not be considered because of the relatively low significance of the issue. Finland has been chosen for this study mainly because of the nationality of the author of the study. However, Finland may also be regarded as an interesting example of a country with a relatively young and small but rapidly-growing investment fund industry.

With a view to generalizing the results of the study, the selected Member States provide sufficient variation in terms of tax treatment. Germany has a long tradition of following strictly the so-called principle of transparency, which at the same time has led to a very complicated tax regime. France is another example of a country adhering to the same principle, though with greater laxity. The United Kingdom in turn has a distinct tax regime in that it treats investment funds and income therefrom much in the same way as in the case of ordinary companies. Finland is an example of the country with a pragmatic grasp of the taxation of investment funds and income therefrom, characterized by the absence of specific tax rules governing the issue. However, in view of the wide variety of tax regimes adopted by different Member States, the study inevitably has its limits as to the generalization of the results to all Member States.

Several limitations must also be made in terms of the types of investment fund to be covered by the study. Since this study takes the perspective of the European Union, the natural criterion, in terms of the types of fund to be covered by the study, is their qualifying as investment funds within the meaning of the UCITS Directive. In line with the scope of the Directive, only investment funds making portfolio investments in transferable securities and

[28] See Lipper Analytical Services.

other financial instruments are included. This limitation has important bearings when considering the tax treatment of non-resident investment funds in the source state of income under national tax rules and relevant tax treaties. Firstly, investment funds covered by the study are treated – for the purposes of domestic law and tax treaties – as portfolio investors, in contrast to direct investors with substantial holdings, or business investors engaging in the management of target companies with a fixed establishment in the source state of income. Secondly, investment funds covered by the study do not generally invest in immovable property situated in the source state, thereby making it unnecessary to consider domestic law and the tax treaty rules of taxing immovable property, which differ significantly from those dealing with movable property.

The second important limitation flowing from the UCITS Directive is that only investment funds marketed to the public, in contrast to those restricted to a group of specified investors, are covered. Consequently, investment funds covered by this study are widely-held by several independent investors.[29] They cannot be controlled by any party of underlying investors. This limitation often has an important bearing when considering, for example, issues related to the abuse of tax treaties or the applicability of controlled foreign corporations (CFC) legislations.[30]

In terms of different tax types, this study covers only taxes levied on income (income taxes), and not taxes on wealth or gift at the level of fund investors.[31] Moreover, only the taxation of investment funds and their investors – but not their management companies, advisory companies or depositaries – is dealt with. The latter usually are taxed more or less in accordance with the regular tax rules applied to companies, though in certain jurisdictions special tax rules may be applied.[32] Certain special taxing situations such as mergers and wind-ups of investment funds are not addressed. Nor are any kinds of indirect taxes covered.[33]

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[29] For further limitations arising from the UCITS Directive as to the type of investment funds, see the discussion in Chapter 2.2.2.

[30] CFC legislations, as a rule, attribute the income of the foreign entity only to those resident investors who hold a minimum of 10 per cent of interest in the entity. See OECD (1996) 63. Of the countries covered by this study, this is the case in Finland and Germany. For Finland, see Helminen (2002a) 132. For Germany, see Endres – Thies (1998) 295. In the United Kingdom, the CFC legislation applies only to corporate taxpayers as opposed to individuals. See Collison – Tiley (2003) 34:64. In France, too, the CFC legislation applies only to corporations subject to the corporation tax. See Moerman (1999) 62.

[31] Wealth and gift taxes may, of course, be of significance when making investment decisions.

[32] This is the case, for example, in Luxembourg and Ireland. In principle, the taxation of management companies may also be of relevance for investors when choosing an investment object. This follows from the fact that the management company could transfer the tax benefit it enjoys to investors of the fund it manages in the form of lower management fees, thereby increasing the return on investment for investors.

[33] For the VAT treatment of UCITS, see Nevelsteen – van den Plas (2003).

1.3 Approach and Research Methods

The approach of this study varies as between the chapters. The examination of the tax treatment of investment fund investments and their tax enforcement at the Member State level carried out in Chapters 3-6 is mainly descriptive. This holds true in particular with respect to Chapters 3 and 5 dealing with the substantive taxation of investment funds and their investors in the selected Member States.

The approach of Chapter 7, dealing with the impact of Community law on the taxation of investment fund investments, is mainly dogmatic. In Chapter 7 the existing income tax case law of the European Court of Justice (ECJ) is first discussed, with a view to developing tools for the subsequent examination of the impact of Community law on the taxation of investment fund investments at the level of the Member States.

Chapter 8 deals with the more general taxing issues arising from the objective of the Community of establishing a functioning single market for investment funds. The considerations put forward in Chapter 8 are more of *de lege ferenda* nature. In particular, Chapter 8 discusses different tax policy issues relevant for the single market, and considers possible tax measures enhancing the realization of the objective.

Despite the different approaches, the research method of greatest importance in this study is the comparative method. However, this is not used as an interpretative aid to clarifying domestic laws of different states.[34] Rather, it is used primarily in the collection of examples of possible ways of treating investment funds and their investors for tax purposes under national laws and tax treaties. Furthermore, the comparative method helps us to gain a deeper understanding of the nature and significance of the tax issues arising among the Member States, when taxing investment funds and their investors. Such understanding is a prerequisite for the evaluation of the possible impact of Community law on national tax laws and tax treaties governing investment fund investments. Similarly, in this way, the requirements and challenges to which tax measures applied at the level of the Member States are exposed, in view of the objective of creating a single market within the Community, can be understood. Finally, the comparative method may also be useful in finding appropriate tax measures which would meet in the best possible way the requirements of Community law and the single market.[35]

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[34] For this use of the comparative method, see Aarnio (1989) 50. For different approaches to comparative law in taxation, see also Skaar (1991) 6-7.

[35] See also Thuronyi (1999) 336, who considers that the integration of the European Union contributes to a greater demand for comparative tax information and analysis. Similarly, Myrsky (1997) 530.

1.4 Materials

There are no earlier studies specifically dealing with the tax treatment of investment funds and their investors within the European Union. The only comprehensive studies on the taxation of investment funds and their investors in the cross-border context have been carried out by the OECD. The first one, *The Taxation of Collective Investment Institutions* from 1977, deals with the matter under study at a very general level and has been helpful in understanding basic problems related to the tax treatment of investment funds and their investors in the cross-border context. The second study, *Taxation of Cross-Border Portfolio Investment: Mutual Funds and Possible Tax Distortions*, concentrated on the taxation of investment funds from the perspective of tax neutrality. The approach and methods employed in it have proven to be extremely useful for the purposes of this study, when issues related to tax neutrality will be under consideration.

Except for the above-mentioned documents, it seems that there have been no comprehensive studies, either in Finland or internationally, which examine both the taxation of investment funds and their investors in the cross-border context. On the other hand, there are some comprehensive studies which deal with the taxation of investment funds and their investors in both the domestic and the international context. However, the use of these studies in view of the subject of the present thesis is somewhat limited, as they typically tend to concentrate on the specific questions arising in the country under study. A typical example of this kind of approach is *Besteuerung von Wertpapier-Investmentfonds* by Stotz from 1998, which examines in great detail the taxation of German investment funds and their investors. In Finland, there are no comprehensive studies on the taxation of investment funds and their investors, even in the domestic context. This is probably because investment funds have been in existence only from the beginning of the late 1980s, whereas, for example, the history of German investment funds began more than 50 years ago. Nonetheless, there are some articles which deal with this matter such as Vapaavuori's *Sijoitusrahaston ja sen osakkaan verokohtelu I-II* (Tax treatment of the investment fund and its investor) from 1998 and 1999.

In dealing with the tax regimes governing investment funds and their investors in different Member States of the European Union, the most important sources of information have been a loose-leaf publication *Investment Funds –International Guide to the Taxation and Regulation of Mutual Investment Funds and Their Investors* by the International Bureau of Fiscal Documentation (IBFD), and the country reports in *Cahiers de droit fiscal international,* Vol. LXXXIIb, on the subject of the Taxation of Investment Funds, by the International Fiscal Association (IFA). Nevertheless,

for the most part, changes in national tax laws governing investment funds and their investors have had to be followed on the basis of academic articles, on account of the rapid developments in this field.

When examining the difficulties arising in the interpretation and application of tax treaties in connection of investment funds, the General Report by Ed and Bongaarts in the *Cahiers de droit fiscal international,* Vol. LXXXIIb, referred to above has been the basic source. In addition, the country reports in the same publication have shed light on the country approaches to this matter. The OECD Model Tax Convention on Income and on Capital has been the principal source for the exploration of general matters relating to the interpretation of tax treaties. Juusela's *Kansainväliset sijoitukset ja verotuksen tehokkuus* (International investments and the efficiency of taxation) from 1998 has been the main source in matters of tax enforcement.

Basic sources of European Community law used in this study have been *European Tax Law* by Terra and Wattel from 2001, *EU Case Law on Income Tax, Part 1* by van Thiel from 2001, *EG-Skatterätt* (EC Tax Law) by Ståhl and Österman from 2000 and *Eurooppaoikeus ja kansainvälinen verotus* (EC law and international taxation) by Vapaavuori from 2003.

Of particular interest has also been *Aktiebeskattning och fria kapitalrörelser* (Taxation of investment in shares and free capital movements) by Ståhl from 1996 which deals with the taxation of share investments made by private investors in certain Member States of the European Union. The viewpoint taken therein is very similar to that of the present study, in that the aim of establishing a single capital market within the European Union is the background against which national tax measures are analyzed. However, the study carried out by Ståhl expressly excluded investment funds from its scope.

1.5 Terminology

The term 'investment fund investment', or briefly 'fund investment', refers to an investment made through an investment fund, as opposed to 'direct investment', which is made without using an investment fund as intermediary. The term is intended to cover the whole course of the investment including both the transactions carried out by the investor (acquisition, holding and disposal of units) and those carried out by the investment fund (acquisition, holding and disposal of underlying securities). When examining the tax treatment of an investment fund investment, it is in most cases necessary to distinguish between the tax treatments of an investor and an investment fund respectively. However, the tax treatments of the two subjects are closely interconnected, in the sense that the tax treatment of an investment fund will

also have an impact on the tax treatment of an investor. Therefore, when speaking at a more general level, it is reasonable to refer to the tax treatment of an investment fund investment which covers both the tax treatment of an investor and an investment fund.

The use of terms referring to collective investment vehicles is inconsistent across different jurisdictions. Currently, several different terms are in use. In this study, the term 'investment fund' is used, in line with the scope of the study, to refer to all collective investment vehicles which fall within the scope of the UCITS Directive. However, when the intention is to refer to an investment fund established under the laws of a particular Member State only, either the official denomination together with the nationality (such as 'French SICAV') is used, or the simple term 'investment fund' with reference to its origin (such as 'Finnish investment fund') is used. In cases where the distinction between investment funds qualifying as UCITS and those not qualifying as UCITS is of significance, reference to 'UCITS' will be made.

1.6 Outline of the Study

This study is organized into nine chapters. Chapter 2 will first briefly discuss some general economic, and to a certain extent legal, aspects of investment funds. The aim is to provide a picture of the structure and operation of investment funds in order to help towards an understand of their functioning in reality. Next, an overview of the regulation of investment funds at the level of the European Union, and in the selected five Member States, will be provided. The discussion covers that primary and secondary legislation of the European Union which has an impact on investment fund investments, and describes the outlines of the investment fund industry and its regulation in the United Kingdom, Germany, France, Finland and Luxembourg.

Chapters 3-6 have as their purpose the description of the current tax treatment of investment funds and their investors in the selected Member States. At the same time, a more general picture is also provided of taxing problems encountered in the context of investment fund investments. Chapters 3-5 are further divided in accordance with the fiscal links connecting an investment fund investment with different tax jurisdictions.

Chapter 3 deals with the taxation of investment funds in the residence state. It begins with a general description of theoretical methods according to which the tax treatment of investment funds may be arranged. Thereafter, the taxation of resident investment funds in the selected Member States is examined. The chapter concludes with a brief survey of alternative tax regimes applicable in other Member States.

Chapter 4 deals with the taxation of investments made by investment funds in the source state of income. The major part of the discussion is concerned with the tax treaty access of investment funds, which generally has a great impact on tax treatment in the source state. The possibilities of applying tax treaties on the level both of investment funds and of underlying investors are examined in the light of the OECD Model Tax Convention. The examination covers the general conditions of applicability, limitation-of-benefits provisions, and specific provisions addressing investment funds or their investors. The examination focuses on tax treaties following the OECD Model Tax Convention. A presentation of country practices on the application of tax treaties in the context of investment fund investments concludes the chapter.

Chapter 5 deals with the tax treatment of fund investors. Three different taxing situations are covered from the perspective of each of the selected Member States. Firstly, the taxation of a resident investor participating in a domestic investment fund is examined. Secondly, the taxation of a resident investor in a foreign investment fund is dealt with. Thirdly, the taxation of a non-resident investor participating in a domestic investment fund is investigated. This general description of relevant tax rules is followed by an evaluation of the differences in the tax treatment between the three situations in each Member State. The purpose of the evaluation sections is to point out the differences in taxation between the three situations, and to provide examples for the purposes of the examination of the impact of Community law on tax laws of the Member States.

Chapter 6 discusses some relevant issues relating to the enforcement of tax laws as far as investment fund investments are concerned. The differences in tax enforcement between investments in domestic as compared to foreign investment funds, from the perspective of national tax authorities, are explored. The discussion covers the enforcement measures enacted both under national tax laws and under international legal instruments.

In Chapters 7 and 8 the focus will be shifted to the level of the Community. A conventional distinction between so-called negative integration and positive integration is drawn. Roughly speaking, negative integration consists of legally enforceable prohibitions on the application of national tax rules in conflict with Community law. Positive integration refers to the coordination of national tax rules within the framework of Community activity.

Chapter 7 provides a fundamental analysis of the impact of negative integration on the tax treatment of investment funds and their investors in the Member States. Negative integration takes effect through the interpretation of primary Community law by the European Court of Justice (ECJ). In this chapter, the case law of the ECJ in the field of income taxation is first analyzed. Subsequently, the impact of Community law, in light of the existing

case law on national tax rules and tax treaty provisions applicable to investment fund investments, is examined.

Chapter 8 analyses the impact of positive integration on the tax treatment of investment funds and their investors in the Member States. The chapter begins with a general discussion of the relevant tax policy objectives, in view of the objective of establishing a functioning single market for investment funds within the European Union. Subsequently, alternative measures are discussed which could enhance the realisation of the objective. The study ends with some concluding remarks on the most important findings of the study, and on future prospects for the single investment fund market.

2 INVESTMENT FUNDS WITHIN THE EUROPEAN UNION

2.1 Investment Funds Generally

2.1.1 Idea and Advantages of Investment Funds

Investment funds are financial intermediaries which obtain money from investors and use it to purchase financial assets.[36] A distinctive feature of investment funds is that they facilitate the pooling of resources of many smaller investors, which in turn will be reinvested cost-efficiently in a large number of securities managed by a professional fund manager. In return, underlying investors are entitled to income and gains produced by the fund on its investments net of expenses.[37]

For an individual investor there are two major advantages in making an investment in securities through an investment fund rather than a direct investment[38] in the same securities.[39] In terms of risk-spreading, or diversification of assets, the investment fund benefits from economies of scale as compared to individual investors, thereby facilitating risk-spreading at a lower cost. In terms of professional management, the investor can reduce the costs of information processing (stock selection, risk management, record keeping etc.) by participating in a securities portfolio through an investment fund rather than holding it directly.[40]

In addition to the widely-acknowledged advantages described above, many fund managers claim to be able to earn abnormal gains, that is, to provide a higher yield than an average investor on the market. This would require the fund manager to be able to identify areas of mispricing and exploit them continuously. In practice, it has appeared to be extremely difficult for an

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[36] Fabozzi – Modigliani (1992) 109. Specifically, financial intermediaries are organizations that issue financial claims against themselves and use the proceeds from this issuance to purchase primarily the financial assets of others. See Sharpe et al. (1995) 9.

[37] Sharpe et al. (1995) 776.

[38] A distinction is usually made between direct and indirect investments. Investments in financial claims issued by financial intermediaries such as investment funds are referred to as indirect investments, whereas the ones made directly without an intermediary are known as direct investments. See Fabozzi – Modigliani (1992) 15.

[39] Sharpe et al. (1995) 776.

[40] See Sharpe et al. (1995) 777 and Fabozzi – Modigliani (1992) 113-114.

investment fund to earn abnormal gains as opposed to merely recouping the additional costs incurred owing to trading of securities.[41] Yet, other advantages gained from investing in an investment fund, rather than a direct investment in securities, may still outweigh any disadvantages, particularly for individual investors with modest financial resources.[42]

2.1.2 Operation of Investment Funds

Below, a possible structure of an investment fund is depicted and the functions of different parties discussed.

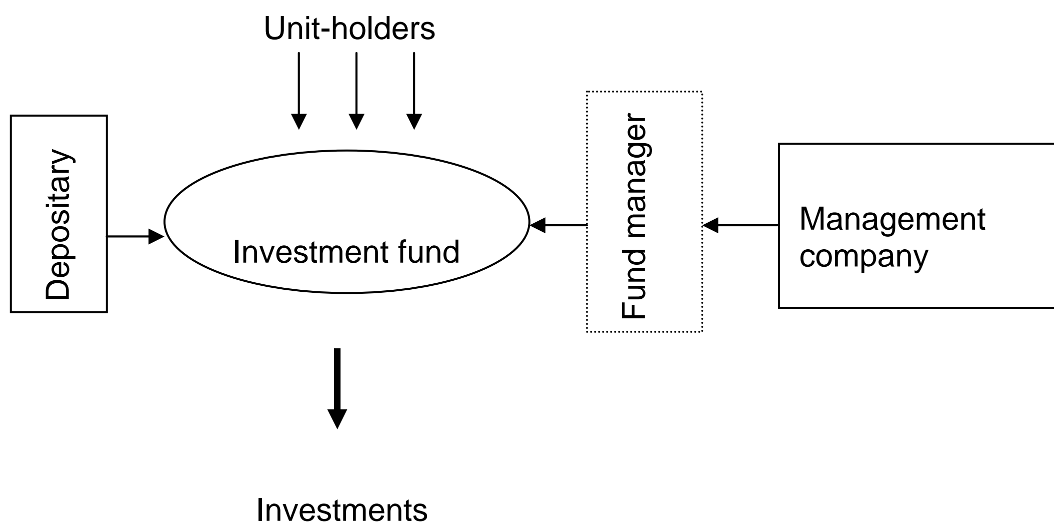

Figure 1. A Structure of an Investment Fund.

Management company. The management company collects money from several investors, pools them in the fund and invests further, according to the investment objectives and policies of the managed investment fund, as described in the fund's rules. Most fund management companies administer several investment funds, each with its own distinctive investment objective. The fund management company acts in its own name on behalf of the underlying investors and uses all the rights related to assets entrusted to it. For the protection of underlying investors, management companies are strictly

[41] See Copeland – Weston (1992) 383-385.
[42] See Copeland – Weston (1992) 384; Sharpe et al. (1995) 777. Other possible advantages may include, among others, liquidity, official supervision and tax benefits. See Puttonen – Kivisaari (1997) 38-39.

regulated. For its services for the investment fund, the management company charges a fee based on a percentage of the fund's average net assets.[43]

Fund manager. The fund manager will be engaged by the management company to take the responsibility for the selection of portfolio investments. The financial performance of a fund depends largely on the decisions made by its fund manager.[44] Broadly speaking, the task of the fund manager is to invest assets so that the best possible return on investment will be achieved within the limits of a given risk level. The investment success of the fund manager is usually measured by the previously-determined comparison index for the investment fund.[45] Sometimes a separate advisory company may be engaged by the management company.

Depositary. The depositary[46] will be entrusted with the assets of the investment fund. Two types of duties are normally imposed by law on depositaries. In the first place, they exercise control over the assets entrusted to them. This includes safe keeping of assets and settlement of trades[47] on behalf of the investment fund, as well as the collection of income arising from the portfolio and the exercise of any other rights in respect of the entrusted assets. In addition, the depositary has an important role in the protection of those who invest in the investment fund. A depositary must, among other duties, oversee that the issuance and redemption of units are carried out, and the value of units calculated, in accordance with the law and the fund rules. For its services, the depositary charges a fee based on a percentage of the fund's average net assets.

Investment fund. The investment fund simply consists of the financial assets purchased with the money obtained from investors, together with possible cash reserves. In receipt of their assets, investors receive units or shares in the fund, each representing a fraction of the total assets. Depending on the legal form, the fund may be a separate mass of assets co-owned by unit-holders, or may be part of the assets owned by the corporate form fund in which investors act as shareholders. The fund management company is obliged to calculate and publish the net asset value (NAV) per unit on a daily basis. Net asset value is obtained by adding up the market values of all the assets (MVA) held by the investment fund, and subtracting from it any liabilities (LIAB) that the fund

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[43] Equity funds typically charge 0,3-3 per cent, bond funds 0,2-1,5 per cent and money market funds 0,2-0,8 per cent. See Dembowski (2000) 91-92. Generally speaking, the more specialized the fund, the more management and analysis efforts are needed, and hence the higher the management fees. Sometimes there is an additional performance-related management fee which is to be paid in case the fund yields better than its benchmark index as determined in the fund's rules.
[44] Puttonen – Kivisaari (1997) 37.
[45] See Puttonen – Kivisaari (1997) 190-192.
[46] In some jurisdictions, the term 'custodian' is widely used.
[47] In other words, a depositary ensures that investors receive the shares they have paid for and sellers the money they are owed.

has outstanding, such as management and depositary fees. Dividing the resulting difference by the number of outstanding units (NOU) produces the net asset value of one unit (NAV=(MVA – LIAB)/NOU)[48].

Unit-holders. Unit-holders of the investment fund are entitled to income generated by the fund net of expenses. The income may generally be received by way of a periodic distribution, or by redemption of units at the net asset value, or as a combination of both.

2.1.3 Classification of Investment Funds by Investment Objective

Equity Fund. An equity fund invests the majority of its assets in shares of companies. Equity funds are the second most popular fund type in the European fund markets, accounting for 30 per cent of the total assets under management in investment funds.[49] On the grounds of different investment policies, equity funds may be classified into several categories, each of them having a somewhat different risk and return profile. On the basis of geographical focus, equity funds can be roughly divided into those investing solely in shares of domestic companies and those investing internationally. International equity funds can be further subdivided into global, country and regional funds. Some equity funds also concentrate on shares of companies in a certain industrial branch rather than on a geographical region.

The income earned by an equity fund generally consists partly of dividends flowing periodically to the fund, and partly of realized and unrealized capital gains. In general, the proportion of dividends to the total income is higher in the funds which invest their money in value shares whose dividend-per-share/price ratio is relatively high. Such funds are often referred to as income funds. On the other hand, the funds which concentrate on the shares of so-called growth companies can be expected to earn most of their income as capital gains. For this reason, they are often known as growth funds.

Bond fund. Bond funds invest their money in long-term fixed-income securities[50]. Bond funds are the most popular fund type in the European fund market, with a share of 33 per cent of the total assets under management in investment funds.[51] Fixed-interest securities are issued mainly by governments, municipalities, international organizations and large companies. Bond funds

[48] See Puttonen – Kivisaari (1997) 34.
[49] See FEFSI (2003). As of mid-2000 the share of equity funds was as high as 47 per cent of total assets under management. This decrease results mainly from the global fall in share prices.
[50] Fixed-income securities earn a fixed rate of interest in the sense that the latter does not change at regular intervals such as annually or semi-annually. At the maturity date of the security, loan capital is repaid to the investor.
[51] FEFSI (2003).

may be classified in terms of the issuer, currency and maturity. In terms of an issuer, bond funds may broadly concentrate on either government bonds or corporate bonds. A so-called high yield fund, or a junk bond fund, is a special type of bond fund, specializing in bonds issued by governments or companies bearing high credit risk. In terms of currency, a distinction can be made between bond funds investing in securities denominated in foreign currency ('international bond fund') and those concentrating solely on securities denominated in local currency ('domestic bond fund'). In terms of maturity[52] bond funds are classified as short-term, intermediate-term or long-term funds.

The income earned by the bond fund consists of two parts. In the first place, the fund receives periodic interest payments by the issuer of the security ('coupon yield'). Coupon yield of a debt security generally depends on the rating class, i.e. the solvency and creditworthiness, of the issuer. The higher the rating of the issuer, the lower is the coupon yield owing to a low default risk. The other part of the fund's income consists of possible capital gains which may be earned by selling securities before their maturity date. The price of a debt-security generally depends inversely on the interest rate level.[53]

Balanced fund. Balanced funds invest their assets in both shares and bonds. Balanced funds accounted for 14 per cent of the total assets under management in European investment funds.[54] The idea of balanced funds is that the fund manager may change the proportion of asset classes in accordance with changing market situations, in order to achieve an optimal asset allocation.[55]

Money market fund. Money market funds invest their assets in money market instruments, bank deposits and bonds with a short maturity period left. They are appropriate for short-term investments for investors preferring their liquid assets to earn some interest with a minimum of risk.[56] Money market funds account for 22 per cent of the total assets under management in European investment funds.[57] Despite their relatively high market share, it must be noted that the majority of investors in money market funds are traditionally companies and other institutions, rather than private investors.

Index fund. The idea of an index fund is to follow the performance of a specified market index.[58] In contrast to actively-managed investment funds, the aim of the passively-managed index fund is to replicate the movements of

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[52] Maturity is the time left until the maturity date which is the date on which a bond issuer promises to repay investor the principal of the bond. See Sharpe et al. (1995) 384.
[53] When the interest rate level increases, the value of debt security decreases and vice versa.
[54] FEFSI (2003).
[55] Puttonen – Kivisaari (1997) 49.
[56] Puttonen – Kivisaari (1997) 47.
[57] FEFSI (2003)
[58] Sharpe et al. (1995) 792.

the chosen market segment by constructing an exactly or nearly similar portfolio, represented by the index depicting the chosen market segment. Index funds generally make extensive use of derivative instruments.

Guaranteed fund. Guaranteed funds provide investors with a guarantee of a minimum performance linked to a certain market index, together with a repayment of invested capital in part or in full.[59] Depending on the investment policy, guaranteed funds are established as equity, bond or money market funds, or as a combination of them. Similarly to index funds, guaranteed funds make an extensive use of derivative instruments. Due to the specific nature, guaranteed funds have only a limited lifetime.

Hedge fund. There are several possible definitions of a hedge fund.[60] They are as often considered to be funds which aim to produce positive returns irrespective of prevailing market situations. Hedge funds have certain peculiarities as compared to conventional types of fund: they usually may invest in a narrow class of assets and have considerable freedom as regards their investment policy. Hedge funds also make extensive use of financial instruments rather than holding conventional securities such as shares or bonds. Recently, hedge funds have seen an enormous increase in popularity, though their relative significance in the fund markets within the European Union is still small.

2.1.4 Classification of Investment Funds by Administrative Policy

Open-end fund. Generally, a distinction is made between open-end and closed-end investment funds. 'Open-end fund' refers to an investment fund whose units the management company stands ready at all times to redeem on a unit-holder's request, at a value corresponding to the net asset value of a unit.[61] Most open-end funds also continually offer new units to investors, though the issuance may also be restricted to certain periods of time, as determined by the fund. Owing to the possibility (or the obligation, as the case may be) to redeem units on request, the capitalization of the open-end fund is 'open' in the sense that the number of outstanding units may change on a daily basis.[62] For an investor the open-end investment fund is a liquid investment object which generally can be easily acquired and sold, irrespective of prevailing supply and demand conditions on the market.

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[59] For guaranteed funds, see Dembowski (2000) 218-224.
[60] For the definitions of the hedge fund, see McCrary (2002) 7.
[61] Fabozzi – Modigliani (1992) 110. This is the economic meaning of the concept. It may have different and more specific content as a legal term.
[62] Sharpe et al. (1995) 484.

Closed-end fund. In contrast to open-end funds, closed-end funds have a fixed share capital, and they are not obliged to redeem shares or units on an investor's request. Instead, their shares are traded on a stock exchange, similarly to any other publicly listed company. Consequently, the value of a share does not have to correspond to the net asset value of the fund, but rather is determined by supply and demand.[63] When the share price is under its actual net asset value, the fund is said to sell on discount. Generally, selling on discount is more common to closed-end funds than selling on premium, where the share price exceeds the net asset value of the fund. Owing to the two variables affecting the price of closed-end funds, they tend to be more volatile than open-end funds.[64]

Distributing fund. On the basis of distribution policy, investment funds are usually classified as either distributing or accumulating (or capitalizing) funds. Distributing funds distribute all, or at least part, of their income periodically (e.g. monthly, quarterly or yearly) to the unit-holders.

Accumulating fund. Accumulating funds do not pay out their income periodically to unit-holders – rather the amount of undistributable increases the price of a fund unit. Sometimes an investment fund is permitted to operate both as a distributing and an accumulating fund. In such a case, an investor may individually choose either to receive a distribution by subscribing so-called 'income units' or 'distributing units', or to accumulate income within the fund by subscribing so-called 'growth units' or 'accumulating units'.

Umbrella fund. Some investment funds adopt multi-level structures instead of acting as a stand-alone investment fund. The most well-known multi-level fund structure is the so-called 'umbrella fund' or 'multi-compartment fund'. An umbrella fund can consist of from two to dozens of so-called 'sub-funds' or 'compartments'. The idea of the umbrella fund is that under the same investment vehicle not only one but several different investment objects ('funds'), with different investment policies, may be offered to investors.[65] The essential advantage of the umbrella fund for investors is the possibility of switching between different sub-funds.[66] In principle, the switch from one sub-fund to another within the umbrella fund could be carried out more easily and at a lower cost than the switch to the units of a completely different fund

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[63] Fabozzi – Modigliani (1992) 110-111.

[64] See Sharpe et al. (1995) 780-781.

[65] See Dohmen (1996). Nevertheless, where the umbrella fund structure is not allowed, fund management companies typically also provide investors with a cost-efficient possibility of switching the units between the investment funds under their management.

[66] From the perspective of the investment funds industry, it may be noted that the umbrella fund structure provides a more efficient means of managing funds. Under the umbrella fund structure, investment management, administration and depositary costs may be reduced by pooling the assets of different sub-funds into one managed fund. See Dembowski (2000) 235.

vehicle. For the purposes of the relations between unit-holders, each sub-fund is treated separately with its own income, losses, expenses etc. The issuance and redemption of units attributable to each sub-fund is made at a price arrived at by dividing the net asset value of the corresponding sub-fund by the number of outstanding units in the sub-fund. Therefore, the investor participates only in the financial result of that sub-fund the units of which he has invested.

Fund of funds. A fund of funds refers to an investment fund whose investment policy is to invest in units of other investment funds ('target funds'). The basic idea is that the investor hands over the selection of investment funds to a professional fund manager instead of choosing them by himself. In terms of risk spreading, a double risk spreading will be attained, *viz.* at the level both of target funds and the fund of funds.

Master-feeder fund. A master-feeder fund structure is a relatively recent innovation through which cost savings may be achieved in terms of administration of funds. It consists of separate underlying investment funds ('feeders') which in turn invest all their assets in another investment fund ('master'). This structure is designed to permit a greater pooling of assets among investment funds having the same investment objectives, while at the same allowing the sale of a variety of 'private label' investment funds to different groups of customers.[67] It is a useful structure for feeder funds which manage a relatively small amount of assets, and which may therefore not be able to take advantage of economies of scale to the same extent as can larger investment funds.

2.2 Regulation of Investment Funds within the European Union

2.2.1 Primary Community Law

In the following two sections, the legal framework of the regulation of investment funds and their activity at the level of Community law will be briefly presented. A more detailed discussion of the nature of Community law and its impact on the tax treatment of investment fund investments follows in Chapters 7 and 8 of the study.

The European Union has as one of its objectives the creation of an internal market characterized by the abolition, as between Member States, of obstacles to the free movement of goods, persons, services and capital.[68] A single

[67] See Rachofsky et al. (1997) 853-854.
[68] Art. 3(1)(c) of the EC Treaty. In the following, simply 'EC' is used to denote 'the EC Treaty' when specific articles are referred to (e.g. Art. 3(1)(c) EC).

financial market is considered to be an essential part of an internal market.[69] A single financial market may in turn be divided into the single capital market and the single financial services market. Consequently, a single financial market calls for the freedom to provide financial services, on the one hand, and the free movement of capital, on the other. In the first place, the providers of financial services must be able to offer their services in other Member States either by setting up a branch or through the cross-border provision of services. In the second place, the free movement of capital must be ensured in the single financial market, as there would be little sense if the goods, *viz.* capital, traded on the market could not circulate freely.[70]

The EC Treaty contains the necessary provisions for the establishment of a single financial market within the European Union. In the first place, Article 43 EC provides the right of establishment and Article 49 EC provides the freedom to provide cross-border services within the European Union. Even though the right of establishment and freedom to provide services constitute directly applicable rights which may be exercised by any natural or legal person, their implementation has proved especially difficult in the field of financial services. The reason for this is the fact that financial activities are strictly regulated in the Member States on grounds of public interest.[71] In order to make the rights conferred by the EC Treaty fully effective in the field of financial services, several measures of secondary legislation in the form of directives have been adopted by the Community. The Community approach on the field of financial services is generally based on the following principles:[72]

1. Harmonization of essential elements of prudential rules and standards;
2. Mutual recognition by the Member States of each other's legislation and supervision of financial institutions (known as the 'one-license principle');
3. Supervision by the country of origin: activities of financialinstitutions carried out in the European Union, whether through a branch or through cross-border suppliers, must be supervised by the Member State in which the head office is established.

The other key element of a single financial market, the free movement of capital, has been realized more slowly than other fundamental freedoms. Contrary to the provisions concerning the free movement of goods and persons and the freedom to provide services, Article 67 (old) EC, on the free movement of capital, contained an obligation to liberalize capital movements

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[69] See Servais (1995) 21-22.
[70] See Servais (1995) 22-23.
[71] Servais (1995) 63.
[72] Servais (1995) 64.

only to the extent necessary to ensure proper functioning of the common market.[73] In the end, the degree of liberalization in respect of capital movements was dependent on the issuance of directives by the Council.[74] In the course of the years, several directives implementing the freedom of capital movements, in accordance with the principle of progressive liberalization, were also adopted.[75]

The progressive liberalization of capital movements culminated in the adoption of the Council Directive 88/361/EEC of 24 June 1988 (hereinafter 'the 1988 Directive').[76] The aim of the 1988 Directive was to achieve a complete liberalization of capital movements by 1 July 1990, the date on which it became effective.[77] The 1988 Directive repealed the approach of a progressive liberalization by obliging Member States to abolish restrictions on movements of capital taking place between persons resident in Member States.[78] The change in approach towards free capital movements was necessitated by the development of the single market and the approaching launch of the first stage of economic and monetary union (EMU).[79] Later, the Maastricht Treaty, effective from 1 January 1994, confirmed the principle of free movement of capital at a higher legislative level by incorporating the rules of 1988 Directive in the Articles 73b-73h of the EC Treaty. In the Amsterdam Treaty, effective from 1 May 1999, the old articles of the EC Treaty (67 – 73a) as well as Articles 73e and 73h relating to free capital movements were abolished and the remaining articles were renumbered as Articles 56 (ex. 73b), 57 (ex. 73c), 58 (ex. 73d), 59 (ex. 73f) and 60 (ex. 73 g) EC.[80]

The fundamental freedoms guaranteed by the EC Treaty, as directly applicable provisions, impact investment funds and fund investors of the

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[73] This limitation derived from the fear that completely free capital movements could have undermined the economic policy of some Member States, or created other imbalances that would have damaged the functioning of the common market. See *Casati,* Case 203/80, para. 9-10.

[74] Art. 69 (old) EC.

[75] The first directive was issued in 1960. The directive divided movements of capital into four categories (A,B,C,D), each of which was subject to a different degree of liberalization. The directive of 1960 was subsequently followed by the directives of 1962 and 1986, which all essentially adopted the same approach. Broadly speaking, this approach worked as follows: in case a transaction fell under the heading A or B, liberalization was unconditional. In the case of the movements covered by the heading C, liberalization was conditional. For transactions covered by the heading D, no liberalization was required. As the lists were amended, more transactions moved to the scope of a higher degree of liberalization. For further details, see Servais (1995) 37-39.

[76] OJ L 178, 08/08/1988 p. 5-18. The 1988 Directive replaced the previous directives of 1960, 1962 and 1986.

[77] See Servais (1995) 54. In the *Bordessa* case, the ECJ held that the provisions of the 1988 Directive can be directly invoked by a person against his own Member State. See *Bordessa and others*, joined cases C-358/93 and C-416/93, para. 35.

[78] Art. 1 of the 1988 Directive.

[79] See Servais (1995) 58.

[80] Hereinafter only the new numbering will be used.

Member States.[81] In addition, there is secondary legislation which essentially puts the right of establishment and the freedom to provide services into effect in the field of investment fund activity.[82] As for fund investors, they may rely on the provision concerning the free movement of capital when investing in investment funds established in other Member States. Moreover, investment funds, in their cross-border investment activity, can be protected by this provision.

To date, despite the direct applicability of the fundamental freedoms, the single financial market has not become a reality. Indeed, it has been said that the single financial market is the major missing piece of the single market[83], one of the major reasons being the uncoordinated national tax laws of the Member States which frustrate the exercise of fundamental freedoms by the EU citizens.

2.2.2 Secondary Law – UCITS Directive

The first step towards the establishment of a single investment fund market within the European Union was taken in the year of 1985 by the adoption of the Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities, widely known as the 'UCITS Directive'.[84] The enactment of the UCITS Directive into national legislations had to take place by 1 October 1989.[85] The rules concerning investment policy were amended in 1988.[86]

In order to eliminate the shortcomings of the original UCITS Directive, two amending directives were adopted at the end of 2001.[87] The so-called 'Product Directive'[88], provides investment funds covered by the UCITS Directive with

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[81] See Schwarz (1991) 51. For this effect, see Chapter 7.

[82] This so-called UCITS Directive will be presented in the following section of the study.

[83] See Lamfalussy Report (initial) 72.

[84] See Schwarz (1991) 51. The UCITS Directive was adopted after a preparation phase of almost two decades. The origin of the Directive dates back to the year of 1966 when a report dealing with the building of a European capital market was issued by a working group set up by the Commission. One of the findings of the report was that equity markets in many Member States were lacking capital supply. Therefore, the report suggested that measures should be taken to support professionally managed investment vehicles that would collect money from the public and reinvest that money into capital markets. See Laux (1986) 189.

[85] By way of exception, for Greece and Portugal the deadline was set to 1 April 1992.

[86] Council Directive 88/220/EEC, OJ L 100, 19/04/1988 p. 31-32.

[87] Shortly before the final adoption of the amending directives, the so-called 'Lamfalussy Report' addressed the modernization and expansion of the investment rules for investment funds as one of the priority issues in the development of European financial markets.

[88] Directive 2001/108/EC of the European Parliament and of the Council of 21 January 2002 amending Council Directive 85/611/EEC on the coordination of laws, regulations and administrative

a greater flexibility in the type of investments they make. The extension of investment policy has brought more investment funds within the scope of the directive, thereby having increased the competition in the European fund markets.[89] The so-called 'Management Company and Prospectus Directive'[90] granted a management company of a UCITS the right to operate throughout the European Union in accordance with the one-license principle, and introduced a so-called 'simplified prospectus' for the purposes of cross-border marketing of fund units. All Member States had to apply the amended UCITS Directive beginning from 13 February 2004.

The objective of the UCITS Directive is to approximate the conditions of competition between investment funds within the European Union, and at the same time to ensure a more effective and uniform protection for fund investors throughout the European Union.[91] This is achieved by laying down common basic rules for the structure of investment funds[92], management companies and depositaries[93], obligations concerning investment policies[94] and information disclosure[95], as well as provisions concerning authorization and supervision[96]. The application of the common rules is also considered as a sufficient guarantee to permit investment funds situated in Member States to market their units in other Member States, on the grounds of the principle of mutual recognition. As a result, an important objective of the UCITS Directive is also to facilitate an easier cross-border distribution of units of investment funds across the Member States.[97] In view of the scope of the present study, and of the considerable body of legislation contained in the UCITS Directive, it is appropriate to confine the following discussion to the definition of the scope of the UCITS Directive, in terms of investment funds, and to the rules concerning the cross-border marketing of units. The regulations concerning management companies and depositaries are for the most part left out of consideration.

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provisions relating to undertakings for collective investment in transferable securities (UCITS), with regard to investments of UCITS, OJ L 41 of 13/02/2002 p. 35-42.

[89] Harju – Syyrilä (2001) 357.

[90] Directive 2001/107/EC of the European Parliament and of the Council of 21 January 2002 amending Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) with a view to regulating management companies and simplified prospectuses, OJ L 41 of 13/022002, p. 20-34.

[91] See Preamble of the UCITS Directive.

[92] Section III of the UCITS Directive.

[93] Section IV of the UCITS Directive.

[94] Section V of the UCITS Directive.

[95] Section VI of the UCITS Directive.

[96] Section IX of the UCITS Directive.

[97] Section VIII of the UCITS Directive. See Laux (1986) 189; Schwarz (1991) 51.

Each Member State must apply the UCITS Directive to investment funds[98] situated within its territory[99], and irrespective of whether these confine the marketing of their units in the Member State or engage in cross-border marketing to other Member States. For the purposes of the Directive, an investment fund is deemed to be situated in the Member State in which the management company is registered and has its head office.[100] The common rules of the UCITS Directive constitute a minimum standard of regulation, and stricter rules may be applied by the Member State to undertakings situated within its territory, provided that the rules do not conflict with the provisions of the Directive.[101] However, the Member State cannot require investment funds from other Member States to follow such stricter rules.[102]

The scope of the Directive is confined to undertakings (U) for collective (C) investment (I) in transferable (T) securities (S) such undertakings being commonly referred to as UCITS.[103] For the purposes of the Directive, a UCITS is defined as an undertaking[104]

- the sole object of which is the collective investment in transferable securities[105] and/or in other liquid financial assets as defined in the Directive[106],
- of capital raised from the public[107],
- which operates on the principle of risk-spreading[108],

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[98] Specifically, the UCITS Directive uses the term 'collective investment undertaking'.
[99] Art. 1(1) of the UCITS Directive.
[100] Art. 3 of the UCITS Directive.
[101] Art. 1(7) of the UCITS Directive. And it should be added, provided that they do not violate primary Community law.
[102] Harju – Syyrilä (2001) 8.
[103] Art. 1(1) of the UCITS Directive.
[104] An undertaking for collective investment may be constituted under contract law, trust law or statute (Art. 1(3) of the UCITS Directive). Hence, all common legal forms used in Member States are included in the scope of the Directive. See Laux (1986) 190. However, partnerships are not included.
[105] The term 'transferable securities' was not defined in the original UCITS Directive, but was generally regarded as including shares and bonds listed on a stock exchange or traded on another regulated and recognized market. Art. 1(8) of the amended UCITS Directive now defines 'transferable securities' as i) shares in companies and other securities equivalent to shares in companies ('shares'); ii) bonds and other forms of securitized debt ('debt securities'); iii) any other negotiable securities which carry the right to acquire any such transferable securities by subscription or exchange. The rationale for confining the investment objects to transferable securities is that it facilitates a simpler valuation and disposal of the assets owned by investment funds. See Laux (1986) 190.
[106] This is a remarkable extension to the original UCITS Directive. Under the amended UCITS Directive, a UCITS is permitted to invest, in addition to transferable securities, in 'other liquid financial assets' as defined in Art. 19(e-h) of the UCITS Directive. Other liquid financial assets comprise units of investment funds, deposits with credit institutions, financial derivative instruments and money market instruments insofar as they are not already covered by the definition of transferable securities. For more detailed descriptions, see Art. 19(e-h) of the UCITS Directive. As a result, many more innovative fund types such as funds of funds, hedge funds and index-tracking funds are included in the scope of the UCITS Directive
[107] A UCITS must raise its capital from the public in the sense that it should not focus exclusively on a limited number of investors. For details, see Meijssen, Investment Funds, 10. Due to this provision the funds aimed exclusively at institutional investors or at certain private investors are excluded from the scope of the Directive.

- the units of which are at the request of holders repurchased or redeemed directly or indirectly out of the undertaking's assets[109].

As mentioned, one of the primary objectives of the UCITS Directive is to facilitate a cross-border distribution of units of investment funds established in Member States throughout the European Union, thereby contributing to the establishment of the single investment fund market as part of the single financial market. In order to attain this, the Directive contains provisions applicable to those UCITS which intend to market their units in other Member States ('host state') than that in which they are situated. The regulation is based on the 'one-license-principle', whereby a UCITS that is authorized and under supervision in one Member State ('supervision by the country of origin') may market its units in another Member State without having to apply for authorization in the latter ('mutual recognition').

A UCITS which markets its units in another Member State must comply with the rules of the host state which do not fall within the field governed by the UCITS Directive.[110] The main regulatory areas that have been left out of the Directive include marketing, advertising and taxation. Hence, they remain subject to the national provisions of each Member State. However such rules must be applied by the host state without discrimination.[111] For the protection of unit-holders, the Directive also requires appropriate measures by the management company to ensure that facilities are available for making payments and for meeting redemption requests on the part of investors, as well as for making available the information which a UCITS is obliged to provide to its prospective and existing investors. The facilities must be provided in accordance with the laws and regulations of the host state.[112]

Before a UCITS is allowed to begin the marketing of its units in another Member State, it has to inform the supervisory authority of its residence state and notify the competent supervisory authority of the host state.[113] For the purposes of this notification procedure, a UCITS has to supply the regulatory authorities in the host state with certain documents, as required by the

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[108] This is perhaps the most significant requirement laid down in the UCITS Directive. In practice, this means that a fund must comply with a number of rules concerning investment and borrowing policies laid down in the UCITS Directive, which essentially set detailed standards of risk-spreading. Those funds, whose investment criteria do not fall within the regulations, cannot qualify as UCITS. The rules concerning the investment policies of UCITS are very extensive and are found in Art. 19-26 of the UCITS Directive.

[109] Therefore, a distinction is made between open-end funds and closed-end funds. Only open-end funds can qualify as UCITS. Closed-end funds are also explicitly excluded from the Directive by Art. 2(1).

[110] Art. 44(1)-(2) of the UCITS Directive.

[111] This is expressly stated in Art. 44(3) of the UCITS Directive, but the prohibition of discrimination also follows from the fundamental freedoms enshrined in the EC Treaty. See Chapter 7 of the study.

[112] Art. 45 of the UCITS Directive.

[113] Art. 46(1) of the UCITS Directive.

Directive. These include (1) an attestation of compliance with the UCITS Directive delivered by the residence state authorities, (2) fund rules or articles of incorporation, (3) the full and simplified prospectus, (4) the latest annual report and any subsequent half-yearly report and (5) details of the marketing arrangements of units in the host state.[114]

A UCITS may begin to market its units in the host state after two months have elapsed from the beginning of the notification procedure, unless the host state authorities raise objections before the expiry of the time limit.[115] The distribution may only be forbidden if the arrangements made for the marketing of units do not comply with the regulations of the host state.[116] Otherwise, the competence to supervise a UCITS belongs, in accordance with the one-licence principle, exclusively to the residence state authorities.[117]

Finally, it must be mentioned that the amended UCITS Directive, in contrast to the original one, also provides the one-license principle for management companies of investment funds. This means that management companies will be able to carry on within another Member State the activity for which they have been authorized in the home state, either by the establishment of a branch or by engaging in a cross-border provision of services.[118] However, such activity is confined to the supply of services to other management companies or investment funds, to the extent that the outsourcing of such activities is permitted by the host state.[119] The establishment of investment funds in the host state is excluded on the grounds of Article 3 of the UCITS Directive, in which an investment fund is deemed to be situated in the Member State in which the management company has its registered and head office. As a result, the cross-border distribution of units continues to be permitted only under the one-license principle applied to a UCITS itself.

[114] See Art. 46(1) of the UCITS Directive.
[115] Art. 46(2) of the UCITS Directive.
[116] Art. 46(2) of the UCITS Directive.
[117] Art. 49(2) of the UCITS Directive.
[118] Art. 6 of the UCITS Directive. For the notification procedures in the case of the establishment of a branch and the supply of cross-border services, see Art. 6a and 6b of the UCITS Directive respectively.
[119] See Harju – Syyrilä (2001) 367.

2.3 Investment Funds in Selected Member States

2.3.1 United Kingdom

Domestic investment funds. The UK investment fund industry is regarded as highly developed on account of the degree of competition and the United Kingdom's position as a centre for international financial services.[120] The UK investment fund market is one of the largest within the EU, accounting for more than 8 per cent of the total assets under management in UCITS.[121] A distinctive feature of the UK investment fund market is the high proportion of equity funds with a share of 70 per cent of total assets under management in UK UCITS.[122] In 2002 there were almost 1 900 UCITS with assets of more than €180 billion of assets under management in the United Kingdom.

The investment fund industry in the United Kingdom is regulated by a system of controls established under the Financial Services and Markets Act 2000 (FSMA 2000). To be marketed to the public, an investment fund is required to be authorized by the Financial Services Authority (FSA) and to comply with its rules. In terms of public marketing, investment funds are divided into two categories: 'regulated schemes' that may be freely promoted to the public, and 'unregulated schemes' that are subject to marketing restrictions.[123] For the protection of investors, regulated schemes must comply with regulatory rules concerning their investment policy which are stricter than those applying to unregulated schemes.

In the United Kingdom, the investment fund qualifying as UCITS may be established either in the trust or the corporate form. The unit trust is an open-end, non-corporate form investment fund, constituted under the terms of a trust deed between a trustee and a fund manager. The assets of the fund are held on trust by the trustee, which is usually a bank or insurance company. Participating units may be bought and sold through the unit trust manager by investors.[124] Unit trusts which constitute regulated schemes are called authorized unit trusts (AUT) and are subject to regulations of the Collective Investment Schemes Sourcebook in the FSA Handbook.[125]

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[120] See Smith – Turner, Investment Funds, 13-14.
[121] See FEFSI (2003).
[122] See FEFSI (2003).
[123] The FSMA 2000 prohibits the promotion of unregulated schemes to the public in the United Kingdom. However, it is possible to promote such a scheme to a restricted class of persons. See Hurley (1997) 821.
[124] See Smith – Turner, Investment Funds, 15; Hurley (1997) 828.
[125] Smith – Turner, Investment Funds, 24-25. Unauthorized unit trusts are not subject to the same regulatory constraints and are available only to limited classes of investors. They are often used by tax-exempt institutional investors. See Smith – Turner, Investment Funds, 15. Unauthorized unit trusts

Since 1997, the UK investment funds can also take the form of the open-end investment company (OEIC).[126] Open-end investment companies (OEIC) are hybrid investment vehicles having some of the features of a company and some of a unit trust. They are regarded as the UK counterpart to the well-known SICAV of Luxembourg and France.[127] However, OEICs are not companies within the meaning of the UK Companies Act, but they constitute a wholly new form of corporate vehicle.[128] OEICs are constituted under the Open-Ended Investment Companies Regulations 2001, and their structure is characterized by its greater flexibility compared to the unit trust. In particular, it is more straightforward to establish an umbrella fund with several sub-funds. In addition to this, each sub-fund may issue a variety of share classes, ranging from distribution and accumulating shares to different charging structures and currency denominations.[129]

Foreign investment funds. The regulation of foreign investment funds in the United Kingdom is also governed by the FSMA 2000 and any rules made under it by the FSA. The FSMA 2000 restricts the public marketing of non-resident funds to those which are recognized by the FSA ('recognized scheme'). In order to become recognized, foreign funds have to fulfill certain conditions laid down in the FSMA 2000. Failure to become recognized ('unrecognized scheme') results in the fund having to restrict marketing to professional investors, as opposed to the non-professional investing public as a whole.[130]

Foreign investment funds which intend to market their units to the public in the United Kingdom are obliged to apply for recognition by the FSA. For the purposes of gaining recognition by the FSA, the FSMA 2000 distinguishes between: 1) schemes constituted in other EU Member States (section 264), 2) schemes authorised in designated countries and territories (section 270)[131] and 3) individually recognized overseas schemes (section 272)[132].

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are taxed as trusts, whereby the income received is taxed first at level of the trustee. For further details, see Collison – Tiley (2003) 30:14.

[126] The form of the OEIC was adopted as part of policies aiming to increase investments in the UK investment funds, especially by non-resident investors. See Hurley (1997) 822 and 829. In addition, there are so-called investment trust companies (ITC) which are corporate form investment companies with a fixed share capital. However, as closed-end investment companies they fall outside the scope of the UCITS Directive.

[127] The SICAV is also used in Belgium and, from 2004, also in Germany.

[128] See Smith – Turner, Investment Funds, 16.

[129] See Smith – Turner, Investment Funds, 16.

[130] Hurley (1997) 827.

[131] Schemes authorized in another country or territory which has been designated by an order made by the Treasury may become a recognized scheme, subject to certain specified conditions. Broadly, they should be of a class specified in a designation order, and provide certain information in the notification procedure. For details, see sec. 17.4 of CIS. See also Hurley (1997) 820.

[132] Any other foreign investment fund not falling within the scope of the previous groups may apply for recognition from the FSA insofar as certain criteria are met. Sec. 272(1) of FSMA 2000. Broadly

Investment funds constituted in the EU Member States, and in accordance with the rules of the UCITS Directive, can benefit from the one-license principle. In order to qualify as a recognized scheme, the UCITS is required to undergo a notification procedure[133] according to which certain information must be provided to the FSA.[134] Recognition is automatic, unless, within a period of two months, the FSA notifies the operator of the foreign fund that the intended marketing arrangements do not comply with UK laws.[135]

2.3.2 Germany

Domestic investment funds. The German investment fund market is the third largest within the EU, after Luxembourg and France, amounting to 17,8 per cent of total markets. Nonetheless, in terms of UCITS, the proportion is a more modest 6 per cent owing to the great number of so-called special funds (*Spezialfonds*) which are restricted to institutional investors and which therefore cannot qualify as investment funds within the meaning of the UCITS Directive.[136] In 2002 there were more than 1 000 UCITS with assets of €200 billion under management in Germany.[137]

As of 2004 major legislative changes concerning the regulation of German investment funds and the taxation of income from investment funds took place in Germany. The two separate sets of legislation, the one governing the regulation of domestic investment funds, i.e. the *KAGG* (*Gesetz über Kapitalanlagegesellschaften*, Law Concerning Capital Investment Companies), and the other governing the regulation of foreign investment funds, i.e. the AuslInvestmG (*Gesetz über den Vertrieb ausländischer Investmentanteile und über die Besteuerung der Erträge aus ausländischen Investmentanteilen*, Law on the Sale of Foreign Investment Shares and on the Taxation of Earnings from Foreign Investment Shares) were consolidated into the *Investmentgesetz* (Investment Act). Similarly, the tax provisions concerning income from domestic investment funds (as laid down in the KAGG) and those concerning income from foreign investment funds (as laid down in the AuslInvestmG)

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speaking, it is required that the arrangements for the schemes are adequate and that protection equivalent to the UK authorized schemes (AUT or OEIC) is afforded to UK investors. For detailed requirements, see sec. 272(2)-(15) of FSMA 2000

[133] Sec. 264(1) of FSMA 2000.

[134] Required documents and information are expressly set out in the sec. 264(3) of FSMA 2000 and in sec. 17.3.1 of CIS.

[135] Sec. 264(2) of FSMA 2000

[136] See FEFSI (2003).

[137] See FEFSI Fact Book 2003.

were consolidated into the *Investmentsteuergesetz* (InvStG, Investment Tax Act).

Traditionally, German investment funds have taken the form of contractual arrangements between the investment management company (*Kapitalanlagegesellschaft*), the special fund assets (*Sondervermögen*) and the unit-holders (*Anteilscheininhaber*). The investment fund, i.e. *Sondervermögen*, has no legal personality. Depending on the terms of the fund rules, the assets may either be held in trust for the investors by the management company (*Eigentum der Kapitalanlagegesellschaft*), or be collectively owned by the unit-holders (*Miteigentum der Anteilinhaber*), the latter being the more common form of ownership.[138] The *Investmentgesetz* also provides for the possibility of the establishment of an open-end investment fund in the form of a company with a variable capital (*Investmentaktiengesellschaft mit veränderlichem Kapital*). Through the introduction of the new form, the competitiviness of the German fund industry is expected to increase.[139]

Under the KAGG German investment funds could be only either distributing or accumulating, because different classes of unit were not allowed.[140] Under the *Investmentgesetz* this restriction will disappear, since it is possible to have different unit classes within the same fund and several sub-funds under an umbrella fund.[141]

Foreign investment funds. Foreign investment funds have traditionally represented a significant market share of the German investment funds market, measured by registration. In 2000 every third fund registered for public distribution in Germany was established abroad, mainly in Luxembourg. In 2002, the total number of registered foreign funds in Germany rose to 1 350 investment funds (or 4 929 including all sub-funds), an annual increase of almost 10 per cent.[142]

In order to become registered for public distribution in Germany, foreign investment funds are required to undergo a notification procedure with the BAFin (*Bundesanstalt für Finanzdienstleistungsaufsicht*). A distinction is drawn between UCITS and non-UCITS.[143] In line with the regulations of the UCITS Directive, the foreign fund promoter must notify the BAFin of its intention to market units of a foreign investment fund in Germany.[144] The

[138] Täske (1997) 455.
[139] See *Investmentmodernierungsgesetz/Entwurf*, p. 159. Under the repealed KAGG it was also possible to establish a company form investment fund but not with a variable capital. However, owing to an unfavorable tax regime applied to corporate form investment funds in Germany, no such entities were in practice established. See Kestler (2003) 675.
[140] Wiesenbart, Investment Funds, 18.
[141] See *Investmentgesetz* § 34.
[142] BaFin Annual Report 2002, 90.
[143] Investment funds not qualifying as UCITS will not be discussed here.
[144] See *Investmentgesetz* § 132.

management company of a UCITS must also appoint a paying agent in Germany (*Zahlstelle*) through which the necessary payments to, and the redemption of units from, German investors may be effected.[145] The German investor, however, is not obliged to make use of the paying agent appointed by the management company.[146]

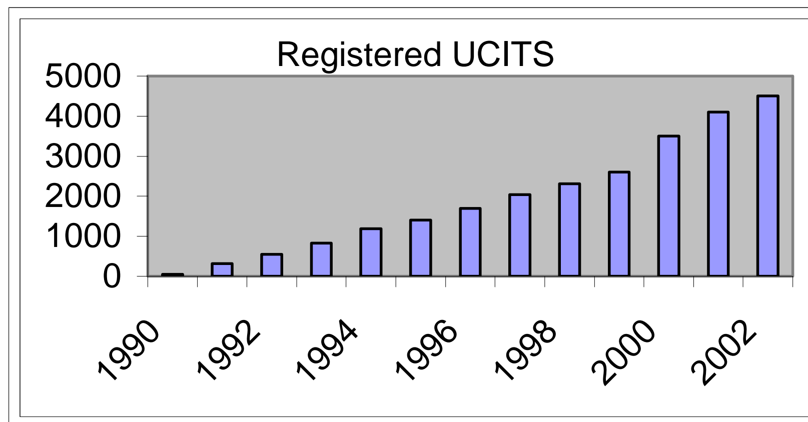

Figure 2. Registered foreign UCITS in Germany in 1990-2002.[147]

2.3.3 France

Domestic investment funds. The French investment fund industry is well-established. It is the largest in the EU, with a share of almost 25 per cent of total assets under management in UCITS, and the second largest in the world after the United States.[148] At the end of 2002 there were over 7 700 investment funds qualifying as UCITS, with assets of more than € 800 billion under management.[149] A relatively high proportion of French investment funds are money market funds and balanced funds, which represent respectively roughly 40 per cent and 20 per cent of total assets in the UCITS. On the other hand, equity funds account for no more than 20 per cent of total assets.[150]

The main law governing French investment funds is the law of 23 December 1988 No 88-1201 which was enacted to implement the UCITS

[145] See *Investmentgesetz* § 131.
[146] See Baur (1999) 9/577. This is of significance with respect to the imposition of German withholding taxes, as will be seen later.
[147] BaFin Annual Report 2002.
[148] FEFSI (2003).
[149] FEFSI Fact Book 2003, 76.
[150] FEFSI Fact Book 2003, 77.

Directive. The law of 2 July 1998 No 98-546 made significant amendments to this by including several innovative fund types within its scope.[151]

French collective investment vehicles[152] which qualify as UCITS may be established either in the form of the SICAV (*sociétés d'investissement à capital variable*) or the FCP (*fonds commun de placement*). The SICAV is a corporate entity whose purpose is to manage securities portfolios. Unlike ordinary French corporate entities, the SICAV has a variable share capital which increases and decreases along with the purchases and sales of its own shares.[153] The FCP represents a co-ownership of securities without legal personality. Owing to the absence of legal personality, the FCP requires a fund management company (*société de gestion*) to carry out its legal transactions.[154]

The SICAV and FCP may operate either as a distributing or as a capitalization fund, or as a mixed fund having both distribution and capitalization shares/units.[155] Since 1998 multiple compartment funds, or umbrella funds, (*fonds à compartiments multiples*), funds of funds and master feeder funds have also been allowed under the French investment fund law, though the last-mentioned cannot qualify as UCITS.[156]

Foreign investment funds. Foreign investment funds qualifying as UCITS and wishing to market their units in France must notify the French supervising authority (*Commission de Operations de Bourse*) at least two months prior to the marketing. There are no other special requirements for foreign UCITS under French laws.[157]

2.3.4 Finland

Domestic investment funds. From 1995-2000, Finland was the fastest growing investment fund market within the EU, with the assets under management growing fifty fold.[158] Nevertheless, the importance of Finland as a market for investment funds has remained low, accounting for only 0,6 per cent of total assets under management in UCITS in Member States.[159] At the end of 2002 there were 321 UCITS with assets of some €16 billion under management. The relative importance of investment funds as a means of investment for

[151] See Blanluet – Portier, Investment Funds, 11.
[152] So-called *Organismes de Placement Collectif en Valeurs Mobilières* (OPCVM).
[153] See Blanluet – Portier, Investment Funds, 12.
[154] See Blanluet – Portier, Investment Funds, 12.
[155] See Blanluet – Portier, Investment Funds, 36.
[156] See Blanluet – Portier, Investment Funds, 11.
[157] Blanluet – Portier, Investment Funds, 39.
[158] See FEFSI, The State of the European Funds Industry.
[159] Source: *Suomen Pankkiyhdistys* (Finnish Bank Association).

households has remained small in Finland as compared to many other Member States.[160]

The first Finnish Act dealing with investment funds was issued as late as 1987 (*Sijoitusrahastolaki* of 1987), and of the 15 Member States, Finland was the last to adopt a legislation governing investment funds.[161] The Investment Fund Act of 1987 was amended twice, in 1994 and 1996, mainly on account of the implementation of the UCITS Directive following EU membership in 1995.[162] In 1999, a completely revised investment fund act (*Sijoitusrahastolaki*, SijRL) was adopted. The reasons for the adoption of a totally revised Investment Fund Act were the rapid development of investment fund activity and stiffer international competition in the field of investment funds, in particular in view of the launch of the common currency euro.[163] The revised SijRL may be regarded as rather modern by comparison with its European counterparts.[164]

Under the Finnish laws, the investment fund may only be established in the form of *sijoitusrahasto*, *viz.* an investment fund which does not constitute a legal entity. In the SijRL, the investment fund is defined as assets acquired and invested in fund business, including all the obligations derived therefrom.[165] Investment funds within the meaning of the SijRL cannot be established in a corporate form, because under Finnish law there is no company form with variable capital available.[166] Because the investment fund lacks legal personality, its activities are to be carried on by a separate management company (*rahastoyhtiö*) which must be a Finnish company limited by shares.[167] The assets of the investment fund must be entrusted to a depositary (*säilytysyhteisö*).[168] In legal terms, the assets of the fund are co-owned by the unit-holders.[169]

With regard to investment policy, the SijRL draws a distinction between funds complying with the requirements of the UCITS Directive, and those falling outside the scope of the UCITS Directive. The investment powers of

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[160] Finnish savings have traditionally been concentrated on bank deposits, owing to tax reliefs that, until recently, encouraged this investment form. The tax-exemption for bank deposits was eventually abolished from the beginning of June 2000 in the wake of other tax reforms aiming at tax neutrality between different forms of investment. See HE 32/1999; HE 103/2000; Tikka (1992) 8-9; Tikka (1993) 42-43.

[161] Harju – Syyrilä (2001) 1.

[162] See HE 59/1996.

[163] See HE 202/1998; Harju – Syyrilä (2001) 7.

[164] Harju – Syyrilä (2001) 1.

[165] SijRL § 2 (1). See also HE 202/1998, detailed arguments to § 2.

[166] In the past, there was a proposal which would have enabled the establishment of the investment company with variable capital. See Harju – Syyrilä (2001) 2-4.

[167] SijRL § 2 (2). The Council of State grants the license for the fund management company. For the legal requirements, see SijRL § 5 (1-4).

[168] For the legal requirements concerning the depositary, see SijRL §§ 9-11.

[169] SijRL § 25(1).

Finnish investment funds qualifying as UCITS are in line with the rules of the UCITS Directive. A broad distinction is usually made between equity funds (ca. 33 per cent of markets in terms of asset value), bond funds (ca. 15 per cent) and balanced funds (ca. 13 per cent).[170]

Investment funds falling outside the scope of the UCITS Directive are referred to as *erikoissijoitusrahasto*, *viz.* a special investment fund, and they are not bound by the provisions of the SijRL concerning investment powers.[171] Nonetheless, it is required that the assets of special investment funds are invested in accordance with the principle of risk spreading.[172] Special investment funds established in Finland include, among others, money market funds (35 per cent), index funds, funds of funds and hedge funds (4 per cent). The revision of the UCITS Directive brought part of the special investment funds under the provisions dealing with the UCITS.[173]

As regards administrative policy, Finnish investment funds are permitted to issue both income and accumulation units in the same investment fund. However, the umbrella fund structure is not permitted under the SijRL.

Foreign investment funds. The marketing of foreign investment funds has been allowed in Finland since 1994. As of June 2001, 77 non-resident fund management or investment companies were offering units or shares for Finnish investors, clearly exceeding the number of Finnish management companies (25) operating on the Finnish investment funds market. While a good half of non-resident fund promoters come from Luxembourg, the rest have their origins in Ireland, Sweden, Norway, the United Kingdom and Belgium.[174] The total number of foreign investment funds, including sub-funds of umbrella funds, marketed in Finland approaches 1000.[175] It has been estimated that Finnish investors have invested some €3,5 billion in foreign investment funds, which would equal approximately 20 per cent of the assets invested in domestic investment funds.[176] However, most of these investors are likely to be other than individuals.[177]

The marketing of units of foreign investment funds in Finland is regulated by the SijRL.[178] In line with the general scope of the SijRL, it applies only to the marketing of those investment funds whose purpose is to collect money

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[170] Source: *Suomen Sijoitusrahastoyhdistys*.
[171] SijRL § 87.
[172] SijRL § 87. Owing to their flexible investment policies, special investment funds are obliged to follow somewhat stricter rules in their marketing and information disclosure than other funds. See SijRL §§ 93 and 95.
[173] Amendments to the SijRL took effect on 8 April 2004. See HE 110/2003.
[174] Source: RATA.
[175] See Harju – Syyrilä (2001) 320.
[176] See Harju – Syyrilä (2001) 320.
[177] See *Taloussanomat* 2 June 2001.
[178] SijRL § 1(1). For activities qualifying as marketing, see Harju – Syyrilä (2001) 305-306.

from the public. The 'public' in the sense of the SijRL means that the circle of potential investors may comprise both non-professional and professional investors.[179] However, it makes no difference whether potential non-professional investors comprise the whole public or whether the public is restricted to a selected group of non-professional investors.[180] By contrast, the SijRL is not applicable if units are marketed exclusively to professional investors, or if according to the fund rules, only professional investors can purchase units.[181]

When it comes to the legal forms of non-resident funds, the SijRL covers all such forms insofar as the investment fund is open-ended.[182] Investment companies with a variable share capital as well as unit trusts also fall within the scope of the SijRL, despite the fact that they cannot be established under the SijRL itself, as far as they are open-ended.[183] In contrast, closed-end investment funds are not covered by the SijRL.[184]

For the purposes of the SijRL, foreign investment funds are divided into UCITS and non-UCITS. While the marketing of investment funds qualifying as UCITS is allowed on the basis of the one-license principle provided for by the UCITS Directive, non-UCITS are required to comply with somewhat more comprehensive regulations.[185]

Prior to marketing, an investment fund qualifying as UCITS is required to undergo a notification procedure with the Finnish Supervising Authority (*Rahoitustarkastus*, RATA).[186] For the purposes of the notification procedure, a UCITS is required to furnish the RATA with the information and documents mentioned in the SijRL, in line with the rules of the UCITS Directive.[187] If the

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[179] See Harju – Syyrilä (2001) 44.
[180] HE 202/1998, detailed arguments to § 1.
[181] See SijRL § 1(2).
[182] Under the SijRL, an investment fund must be open in its wider sense, so that not only is its capitalization open, but also the potential investor circle is not limited to a certain group of investors. See Karjalainen – Parkkonen (2003) 13.
[183] See HE 309/1992, detailed arguments to § 2.
[184] However, the Securities Market Act (*Arvopaperimarkkinalaki*) may apply to a closed-end investment fund provided that it is marketed to the public. See Karjalainen – Parkkonen (2003) 14; Harju – Syyrilä (2001) 45.
[185] A non-UCITS is required to apply for marketing approval with the Council of State (SijRL § 129(1)). Generally speaking, the marketing of a non-UCITS is permitted only if the protection of unit-holders is sufficiently comparable to that provided by the SijRL. In a case where the foreign investment fund is established in a so-called tax haven it is likely that no marketing permission will be granted. This follows from the requirement of competitive neutrality between domestic and foreign investment funds. In particular, through such investment funds, Finnish investors could easily escape the tax supervision of Finnish authorities. For more details of the application and authorization procedure, see Harju – Syyrilä (2001) 312-315.
[186] SijRL § 128(1). For the details of the notification procedure, see Harju – Syyrilä (2001) 306-311.
[187] For a comprehensive list, see SijRL § 130(1)(1-8).

RATA has not raised objections within two months, a UCITS may start the marketing of units in Finland.[188]

2.3.5 Luxembourg

The success of the Luxembourg fund industry has its origins in the year 1983, when the first laws concerning the regulation of investment funds and the supervision and control of the financial sector were adopted. In 1988 Luxembourg took an important step, by being the first Member State of the EU to implement the UCITS Directive.[189] Since then, the investment funds industry has been expanding rapidly in Luxembourg. Presently the amount of assets managed by the Luxembourg investment funds is the second largest in the EU, with a share of almost 23 per cent of total assets under management in UCITS. As of December 2003, the number of Luxembourg-based investment funds was 1870, the total net asset value of which reached €953 billion. The UCITS is the most significant type of investment scheme, both in terms of the number of funds and the assets under management. They represented 61 per cent of the total number of funds. The assets managed by Luxembourg funds qualifying as UCITS represented more than 76 per cent of the total net asset value of Luxembourg funds.[190]

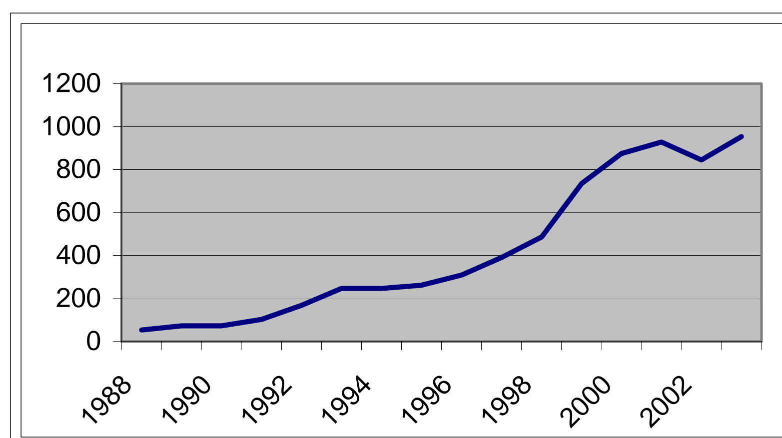

Figure 3. Assets (in €bn) of Luxembourg Investment Funds in 1988-2003.[191]

A distinctive feature of the Luxembourg funds industry is that it is strongly directed towards international markets. By providing favorable conditions for

[188] SijRL § 128(2).
[189] For the history of Luxembourg investment funds, see Steichen (1989) 75-77.
[190] CSSF (2003).
[191] CSSF (2003).

investment fund promoters, Luxembourg has established itself as a leading hub for cross-border distribution of units between Member States. Remarkably, more than 80 per cent of the investment funds authorised for cross-border distribution under the UCITS Directive are established under the laws of Luxembourg.[192] The majority of the leading European financial institutions have established a subsidiary in Luxembourg in order to establish investment funds under the Luxembourg law, with a view to marketing them mainly back into their home countries but also to other Member States.

The law by which the investment funds in Luxembourg are governed is usually referred to as the Law of 30 March 1988 (*La loi du 30 mars 1988*). It aims to provide investment funds with the maximum flexibility, within the limits of the regulations of the UCITS Directive. Following the promulgation of the amended UCITS Directive, Luxembourg issued a new law, effective as of 1 January 2003, governing investment funds. The Law of 20 December 2002 (*La loi du 20 December 2002*) follows the systematic classification of the Law of 30 March 1988, by distinguishing between so-called Part I funds (which are the funds which can be classified as UCITS within the meaning of the UCITS Directive)[193] and Part II funds (which are other undertakings for collective investment not qualifying as UCITS)[194]. There are transitional provisions, applicable to Part I funds established under the Law of 30 March 1988 and set up before 13 February 2002, which provide such funds with the possibility of remaining subject to the prior law until 13 February 2007.[195]

There are two general types of entity that can be used as an investment fund in Luxembourg. First, an investment fund can be formed as a collective investment fund, in which case it is called the FCP (*fonds commun de placement*). The FCP is made up of a collection of investments and held by co-owners (unit-holders) of a fund. It does not have a legal personality itself, and accordingly has to be managed by a separate management company (*société de gestion*). The FCP accounts for 52 per cent of investment funds registered in Luxembourg.[196] Second, an investment fund can be established in a corporate form. The most widespread and well-known investment fund of this type is the SICAV (*société d'investissement à capital variable*), an investment company with variable capital.[197] It accounts for 46 per cent of Luxembourg investment funds.[198]

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[192] FEFSI (2003).
[193] *Organismes de placement collectif investissant en valeurs mobilières* (OPCVM).
[194] *Organismes de placement collectif spécialicés* (*OPC spécialicés*).
[195] See Art. 134 of the Law of 20 December 2002. See also CSSF Circular 03/87, p. 5.
[196] CSSF (2003).
[197] In fact, the SICAV is an investment company which has adopted the form of a public limited company (*société anonyme*) under Luxembourg law. Unlike the conventional public limited companies, the SICAV's articles of association must provide that the amount of the capital shall at all

Both the FCP and SICAV can operate either as a stand-alone fund or as a part of an umbrella fund. An umbrella fund is considered to be a fund with a multitude of sub-funds within a single entity. On average, it consists of five to six compartments, which can be used, inter alia, for investments in securities in different geographical regions or economic sectors. The umbrella fund structure has turned out to be extremely popular among the fund promoters.

In legal terms, the umbrella fund constitutes a single legal entity.[199] Since the umbrella fund constitutes one legal entity, all sub-funds must be governed by a single set of management regulations which forms the legal basis of the umbrella fund. Consequently, the rules for valuation and redemption of units, as well as general investment restriction principles such as borrowing policy and the use of derivatives, must be the same for the sub-funds. Despite the single entity principle, for the purposes of the relations between unit-holders each sub-fund will be deemed to be a separate entity. The investor may restrict his investment to one or more sub-funds without taking part in the investment schemes of other sub-funds. To facilitate this, the value of units is calculated separately for each sub-fund, by dividing the net asset value of the sub-fund in question by the number of outstanding units in the sub-fund. In principle, the investor of an umbrella fund should have the right, subject to reasonable limits, to switch from one sub-fund to another without the payment of commission.[200]

2.4 Conclusions with a Comparative Survey of Other Member States

The preceding sections show that the United Kingdom, France, Germany and Luxembourg are important players in the European investment fund markets. The size of the domestic fund industry of the three first-mentioned can be explained by the relatively high population of the countries as compared to many other Member States. The size of the Finnish fund industry is small both in absolute and relative terms, though the pace of growth has recently been among the highest within the EU.

When it comes to the importance of cross-border activity, Luxembourg clearly dominates as the most popular domicile for investment funds marketed

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times be equal to the net asset value of the company. The SICAV is subject to the provisions applicable to public limited companies insofar as the Law of 20 December 2002 or the Law of 30 March 1988 do not derogate therefrom. See Art. 25-26 of the Law of 20 December 2002 and Art. 23 – 24 of the Law of 30 March 1988.

[198] CSSF (2003).

[199] See Art. 133(1) of Law of 20 December 2002 and Art. 111(2) of Law of 30 March 1988.

[200] See Art. 133(2)-(6) of Law of 20 December 2002. Prior to the Law of 20 December 2002, the umbrella fund structure was dealt with in IML Circular of 29 January. The Law of 30 March 1988 did not contain specific rules concerning the umbrella fund.

to other Member States. Apart from Luxembourg, Ireland is presently the only jurisdiction from which investment funds are being marketed to other Member States in significant numbers. However, in many Member States, foreign investment funds play an important role, at least in view of their numbers. In Germany and Finland, there is relatively the highest proportion of foreign investment funds to domestic funds, this being almost 80 per cent. Unfortunately, there generally are no statistics available as to the amount of assets actually invested to foreign investment funds by resident investors.

As far as the legal forms available to open-end investment funds are concerned, in the United Kingdom, France and Luxembourg the choice may be made between a corporate and non-corporate form when establishing an investment fund qualifying as UCITS. Of other Member States, The Netherlands[201], Belgium[202] and Ireland[203] also permit both corporate and non-corporate form investment funds to be established. As of 2004, a German investment fund may also be established in the form of an investment company with a variable capital. However, in Finland only a non-corporate form is possible for investment funds qualifying as UCITS. The same is true for Sweden[204].

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[201] See Kosters – Mooij (1997) 641-643.
[202] See Ballon (1997) 284-286.
[203] See Wall – O'Donnell (1997) 498-499.
[204] See Gunne (1997) 778.

3 TAXATION OF INVESTMENT FUNDS IN THE RESIDENCE STATE

3.1 Introduction

When considering the tax treatment of an investment fund investment, a distinction may be drawn between three different taxing events.[205] First, the income received by the investment fund may be subject to tax in the source state of income (investment level taxation). Second, the income received may be taxable at the level of the investment fund in its residence state (fund level taxation). Third, the income received on the basis of the investor's participation in the investment fund may be subject to tax in the investor's residence state (investor level taxation).

In Chapters 3 to 5, the tax treatment of investment fund investments will be considered separately in the three different taxing events. In terms of consistency, examination should commence from the investment level taxation in the source state of income, which represents chronologically the first taxing event in the chain of an investment fund investment. However, owing to the fact that the tax treatment of an investment fund in the source state of income may, particulary in view of tax treaty access, depend crucially on its tax treatment in the residence state, it is also appropriate to start examination from the fund level taxation. Consequently, in the following, first the principal problems encountered and the methods available when arranging the taxation of an investment fund in its residence state are discussed. Thereafter, taxation of investment funds in the selected EU Member States is presented.

3.2 Taxation of Investment Funds Generally

The use of an investment fund as an intermediary for a portfolio investment is often, from an economic perspective, a feasible solution for individual investors. As shown earlier, the advantages gained from the economies of scale and professional management related to investments through funds suggest an increase in the expected pre-tax rate of return on investment, as

[205] See Ed-Bongaarts (1997) 37; Vapaavuori (1998b) 488.

compared to direct investments in the same underlying securities.[206] In practice, rational investment choices should not be made based on pre-tax rate of return but rather on post-tax rate of return on investment. The otherwise rational choice of using an investment fund as intermediary would be distorted if, based on post-tax considerations, an investor decided not to make his investment through an investment fund due to a lower expected rate of return as compared to a direct investment. The aim of tax neutrality, removing any distortion in the investor's choice between a direct investment and an investment fund investment through tax provisions, has influenced the way in which the tax treatment of investment funds has been arranged throughout the European Union, and, it should be added, also worldwide.

The widely-accepted policy objective of taxing investment funds is to establish a neutral tax regime, in the sense that this should not influence investors' choices between investing directly or through an investment fund in the same underlying securities. This policy objective is often referred to as the principle of transparency.[207] It follows that the chief problem in arranging the taxation of investment fund investments is how to achieve the transparency of the investment fund interposed in the chain between investors and underlying investments for tax purposes. Despite the common policy objective, the methods adopted by countries to achieve transparency and tax neutrality differ. The different methods are partly explained by the variety of legal forms which investment funds may take, but also by differences in national tax regimes generally, in relation to the taxation of corporations and capital income. In addition, the extent to which transparency is sought by the legislator does have its impact on the choice of methods.

The extent to which the transparency of investment funds is sought often will determine the methods needed to achieve the policy objective, as well as their complexity. The concept of 'full transparency' refers to the situation where the taxation of an investment in the hands of the investor is the same irrespective of whether it is made through the investment fund or directly without an intermediary.[208] In terms of tax policy, full transparency therefore reflects the objective of tax neutrality.[209] However, similarly to other policy objectives, the legislator often confronts a trade-off between neutrality and other desirable objectives. It is widely acknowledged that full transparency, at its best, serves as an ideal outcome of tax policy against which the existing or

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[206] See Chapter 2.1.1 of the study.
[207] See Amonn (1971) I/61.
[208] See Lindencrona (1972) 173.
[209] Lindencrona (1972) 173. The concept of tax neutrality is discussed in greater detail in Chapter 8.2.1 of the study.

intended tax measures can be assessed.[210] It is however not a sustainable premise on which the tax treatment of investment funds should solely be built.[211] The deviations from the ideal of full transparency vary, depending on the legal form in which the investment fund is established, and on the prevailing capital income tax regime, but also on the amount of different jurisdictions involved in the chain of taxing an investment fund investment.[212] In the following, the different dimensions of full transparency, and possible deviations therefrom, are addressed in the one-country case – where the source state of income, as well as the residence state of the fund and investor respectively, are the same.[213] At the same time, some typical measures taken by countries to facilitate transparency are presented.

The most conventional aspect of full transparency is the aim of eliminating economic double taxation arising from the interposition of the fund between the investor and underlying investments. In terms of legal form, a broad distinction is often drawn between the corporate form and the contractual form investment fund. The legal form of the investment fund is a natural starting point when discussing the tax treatment of the investment fund, as it generally determines the fund's status for tax purposes. Should the fund have adopted the form of a corporation, it would generally be treated as an intransparent legal entity, subject to tax on its income, *viz.* a tax subject separate from its shareholders. Consequently, to avoid the economic double taxation of income resulting from the corporate legal form[214], tax relief must be given either at the fund or the investor level.[215] This is sometimes referred to as 'fiscal neutralization' of the investment fund.[216] Should the investment fund however be based on contractual arrangements, it would not be considered *per se* as an intransparent legal entity subject to tax on its income. Instead, the income generated by such a transparent entity would be allocated on a pro-rata basis to its participants, the latter being subject to tax on the income instead of the

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[210] See Lindencrona (1972) 173, footnote 4.

[211] Amonn (1971) I/62; Ed – Bongaarts (1997) 37.

[212] See Lindencrona (1972) 173. As a general rule, the more taxing jurisdictions are involved, the more difficult to achieve full transparency.

[213] It is proper to use this case as the model to explore the problems of achieving full transparency on account of its simplicity. However, the one-country case does not reflect particularly well today's economic reality, with its considerable cross-border activity. Full transparency in the two-country and three-country, or triangular, cases are addressed in Chapter 8.2.1.2 of this study.

[214] The income would first be subject to corporate tax at the fund level, and subsequently subject to income tax in the hands of the shareholders.

[215] See Amonn (1971) I/66.

[216] See Amonn (1971) I/61.

entity.[217] The problem of economic double taxation therefore does not, in principle, arise in connection with contractual forms of investment funds.[218]

The concept of full transparency extends beyond the mere elimination of economic double taxation, in the sense that other potential deviations between the taxation of an investment fund investment and a direct investment must also be taken into account. Broadly speaking, the additional aspects of full transparency may be distinguished into, on the one hand, matters concerning the transformation of income at the fund level, and on the other, those to do with the moment of receipt of income for taxing purposes by the underlying investor.[219]

The transformation of income refers to the situation where the type of the income which was originally received by the investment fund changes into another type of income when distributed to the investor.[220] Full transparency would require that the income retains its character, as if the investor had received the same income directly without an intermediary, *viz.* there should occur no transformation of income at the fund level.[221] The transformation of income would generally occur in the case of corporate form investment funds, the distributions of which would generally be reclassified as a dividend, irrespective of the original items of income received by the fund. Moreover, irrespective of the legal form, the transformation of income would also occur to the extent that fund shares or units are disposed by the investors with the consequence that a capital gain would be realized for tax purposes.

Whether the transformation of income is considered undesirable from the tax policy point of view depends crucially on the general tax regime applied to capital income. For example, where all types of capital income are treated in the same way for tax purposes (e.g. in terms of tax rate, deductions, losses, reliefs), the transformation of income is irrelevant. Should, however, different types of income be treated differently in taxation, the transformation of income could turn out to be either advantageous or disadvantageous for underlying investors, as compared to a direct investment.

The transformation of income at the fund level, where appropriate, is often prevented by the application of special tax rules. Such rules typically facilitate the so-called ’flow-through of income’[222], whereby the original items of income received by the investment fund retain their character when distributed

[217] See Amonn (1971) I/65.
[218] However, investment funds based on contractual arrangements may be equated with intransparent entities for tax purposes by law, in which case the problem of economic double taxation must be resolved.
[219] See OECD (1977) para. 52-56.
[220] See OECD (1977) para. 52-53.
[221] See Lindencrona (1972) 176.
[222] Sometimes this is also referred to as ’pass-through of income’.

to underlying fund investors. Additional measures may also be taken to prevent the transformation of income to capital gains in case fund units or shares are disposed of by investors.

Full transparency with regard to the moment of receipt of income would require that the fund investor is considered, for tax purposes, to receive the income at the same moment, *viz.* in the same tax year, in which the investment fund receives the income.[223] A deviation from full transparency would occur insofar as the income could be accumulated in the fund, and thereby not be taxed on a yearly basis in the hands of fund investors, whereas the same income would be taxable yearly in the case of a direct investment. The possibility for the accumulation of income concerns mainly investment funds treated as intransparent taxable entities either on grounds of the legal form or specific tax rules, in which case investors would generally be taxable only in case of a distribution or disposal of units or shares.

The lack of transparency with regard to the moment of receipt of income typically works for the benefit of underlying investors.[224] For example, whereas a dividend or interest received on the basis of a direct investment in securities would be taxed yearly in the hands of investors, such income could be accumulated, and taxation thereon deferred, when received through the investment fund. Of course, accumulation of income is advantageous only insofar as the investment fund enjoys a more favorable tax treatment than underlying investors in respect of the accumulated income.

The advantageous accumulation of income may be prevented by applying the so-called 'deemed-distribution approach' to income received by investment funds. Under the deemed distribution approach, the income received but not distributed by the investment fund during a tax year is treated as distributed for the purposes of taxing fund investors where no actual distribution takes place. The tax advantage resulting from the accumulation of income for investors may also be eliminated by taxing the undistributed income at the fund level, thereby compelling the investment fund to distribute its income to underlying investors.

In aggregate, full transparency must be understood only as a theoretical ideal of arranging the taxation of investment funds. Deviations arising from full transparency are often dependent on the legal form of the fund. On the other hand, the more particular tax features are linked to different types of capital income, the more difficult it is to avoid the impact of the interposition of an investment fund on the taxation of income in the hands of underlying investors. Finally, in an international context, where more than one country

[223] See OECD (1977) para. 54-56.
[224] See Lindencrona (1972) 176.

exercises its taxing right in the course of an investment fund investment, additional deviations from full transparency are inevitable, as will be demonstrated later in Chapter 8 of this study. Nevertheless, despite its obvious defects, it is indisputable that the principle of transparency has significantly influenced the way in which the tax treatment of investment funds has been arranged throughout the Member States. However, the extent to which transparency is sought by legislators naturally differs from jurisdiction to jurisdiction, and is dictated also by other conflicting tax policy objectives.

Finally, it must be mentioned that there is an alternative view to arranging the taxation in line with the principle of full transparency. According to this view, the principle of full transparency may be abandoned in view of the effect referred to as the 'substitution of securities' in the context of investment fund investments.[225] The substitution of securities arises insofar as securities, *viz.* shares, bonds etc., are bought and managed for the fund investor but are replaced by other securities, *viz.* units or shares of the fund, issued by the management company or by the fund itself. Owing to the substitution effect, the investor is entitled to income on the basis of the units or shares of the fund, but cannot demand the income received by the fund on the basis of underlying securities by the fund.[226] In particular, it may then be argued that the original nature of securities purchased by the fund changes when they are substituted by other securities, to such an extent that the principle of full transparency loses its weight.[227] The substitution effect has gained additional relevance in the wake of modern fund products such as a fund of funds, which are liable to add to dissimilarities between the nature of original securities and the units or shares issued by the fund and held by its investors.[228] Consequently, it is arguable that the concept of substitution of securities cannot be totally ignored by the legislator when arranging the taxation of investment funds and their investors.[229] Obviously, the substitution effect also serves legislators as a plausible argument against aiming for transparency, at least in its strictest forms, though this is seldom expressly referred to.

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[225] See Amonn (1971) I/62-I/63.
[226] Ed – Bongaarts (1997) 37.
[227] An extreme example of this would be the transformation of a real estate into a fund unit in the case of real estate investment funds. In accordance with the substitution effect, it may then be questioned whether a direct and fund investment in the same real estate should be treated similarly for tax purposes, given the different nature of the two securities, for example, in terms of liquidity.
[228] For example, in the case of a fund of funds, the question arises as whether the relevant underlying securities are those held by the fund of funds, *viz.* units in other funds, or those held by the funds in which the fund of funds participates. In the latter case, it must be noted that, in view of multi-level fund structures generally, it becomes increasingly difficult to track down the original underlying securities.
[229] See Amonn (1971) I/63; Ed – Bongaarts (1997) 37.

3.3 United Kingdom

UK investment funds, irrespective of the legal form[230], are for the most part subject to corporation tax on their income, under the normal taxing rules applied to investment companies.[231] Funds in the form of an umbrella fund are not treated as a company, but rather each sub-fund is deemed to constitute a separate investment fund which is treated as a company for tax purposes.[232]

As a rule, the taxable income of the investment fund consists of income less expenses of management. An important exception to the normal tax treatment of UK companies is that the fund is exempted from tax on capital gains[233] and on trading income derived from futures and options contracts.[234] Under UK tax law, resident companies generally are not subject to tax on dividends received from other UK companies. This general rule applies also to UK investment funds, so that dividend income paid to the investment fund by a resident company flows through the fund with no further tax liability at the fund level. However, the tax exemption does not extend to dividends received from non-resident companies – these dividends therefore constitute taxable income for UK investment funds. Interest income, irrespective of its source, is treated as taxable income for the fund. A relief will be given, in the form of a credit against corporate tax liability or of expense deductible from taxable income, for any withholding tax suffered abroad by the fund in respect of taxable income.[235] The taxable net income of the fund is subject to corporation tax at a rate of 20 per cent.[236]

Apart from the general tax regime applied to UK investment funds, a special tax treatment exists for the UK funds qualifying as 'bond funds'. Broadly speaking, a UK investment fund qualifies as a bond fund if more than 60 per cent of the assets held by the fund consist of debt securities or other interest-bearing instruments. The bond fund is allowed to classify its distribution as interest, as opposed to the normal practice of UK investment funds, where distribution is classed as dividend. The interest distribution results in a tax deductible cost, thereby neutralizing the taxable interest income, with the consequence that there is no corporate tax payable at the fund level. However, interest distributions are subject to a 20 per cent withholding tax at

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[230] The unit trust and OEIC are treated in the same way for UK tax purposes. Therefore, the term 'investment fund' is used to refer to both the unit trust and OEIC. However, where appropriate, the terms unit trust or OEIC respectively are used.
[231] Smith – Turner, Investment Funds, 62-64.
[232] Smith – Turner, Investment Funds, 65.
[233] Sec. 100(1) of the TCGA (Taxation of Chargeable Gains Act 1992).
[234] Sec. 468AA of the ICTA (Income and Corporation Taxes Act 1988).
[235] Smith – Turner, Investment Funds, 65.
[236] Smith – Turner, Investment Funds, 65. Until 1996, different rates applied depending on the nature of the fund's underlying assets.

source when paid to resident investors. For non-resident investors distributions can generally be made without deduction at source.[237]

3.4 Germany

As from 2004, the tax treatment of domestic investment funds, *viz. Sondervermögen*, is regulated by *Investmentsteuergesetz* § 11(1) (InvStG, Investment Tax Act).[238] The investment fund is technically subject to corporation tax, despite not being a legal entity. This is carried out by treating the investment fund as 'special purpose assets' (*Zweckvermögen*)[239] within the meaning of the German Corporate Tax Act (*Körperschaftsteuergesetz).* In the first place, this results in full corporate tax liability (*unbeschränkte Körperschaftsteuerpflicht*).[240] However, based on InvStG § 11, the investment fund is also exempt from both the corporation tax (*Körperschaftsteuer*) and business tax (*Gewerbesteuer*). As a result, the taxation of income takes place only at the level of underlying investors.[241] Notably, the taxation of German investment funds and their resident investors has traditionally strictly followed the principle of transparency.

The introduction of the new corporate and dividend tax system in the Tax Reduction Act (*Steuersenkungsgesetz,* StSenkG)[242] had its impact on the taxation of German investment funds. Unlike in the previously applied

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[237] For further details of the bond fund regime, see Smith – Turner, Investment Funds, 66-67.

[238] InvStG § 11(1), which corresponds to KAGG § 38(1).

[239] More specifically, 'special purpose asset' is defined as a distinguishable asset which is legally or factually so earmarked for a specific purpose that no other taxable entity can either dispose of the assets and the receipts arising therefrom as an owner, or unilaterally cancel the earmarking for the specific purpose. See Stotz (1998) 82-83; Dehnen et al. (2000) 480.

[240] Stotz (1998) 83.

[241] Until 2001, there was one exception to the full tax exemption of investment funds, in the sense that corporate tax liability was not only nominal. Under the imputation system applied in Germany until 2001, a special regime was applied to imputation credits (*Körperschaftsteuerguthaben*) attached to dividends received by the investment fund. Although the investment fund as a tax-exempt entity was not as such entitled to imputation credit, it could receive dividend income including a refund of imputation credit attached to dividend. When the fund later redistributed, or was deemed to have distributed, dividend to its unit-holders, it was obliged to pay an equalizing tax (*Ausgleichssteuer*), at the rate of German corporation tax, on the net amount of dividend in order to bring the fund investors and direct investors to a similar position as required by the transparency principle. For the investment fund, the possibility of using the refund of imputation credit for a limited period of time, i.e. a maximum of 12 months, and of deducting expenses against it, brought a tax advantage.

[242] The original Proposal of the Tax Reduction Act contained radical changes to the taxation of investment funds. Based on the proposal, investment funds would have been subject to corporation tax of 25 per cent. Under the Proposal, distributions from investment funds would have been taxed as dividends and thus also have been eligible for the half-income procedure. Dividends derived from capital gains would have been tax-exempt for individuals. The investment fund industry raised serious concerns about the effects of the proposed tax regime on the fund industry, and eventually the proposed tax regime was not enacted. Bogenschutz – Wright (2000a) 19.

imputation system, corporation tax paid by the distributing company is no longer creditable, but at the same time only half of the dividend income received by the private shareholder is taxable. For corporate shareholders, dividend is tax free.[243] For investment funds, dividend income is not taxable, but corporate taxes are no longer creditable at the level of unit-holders.[244] When a dividend is paid to an investment fund, a withholding tax (*Kapitalertragsteuer,* KapSt) at the rate of 20 per cent is levied, unless a certificate confirming the tax-exempt status of the fund is submitted to the payer. Owing to tax exemption, the withheld taxes are refunded to the fund on request. The same applies to the withholding tax on interest income (*Zinsabschlagsteuer,* ZASt).[245]

Under the KAGG, German investment funds were not, as tax-exempt entities, able to credit foreign withholding taxes[246], but these were credited at the level of underlying investors. However, the InvStG provides for the alternative possibility of deducting foreign withholding taxes as an expense from the income calculated at the fund level.[247]

In accordance with the transparency principle, a tax must, as a rule, be withheld on income that would have been subject to withholding tax when derived through a direct investment.[248] German investment funds are obliged to levy a withholding tax on dividends, whether distributed or accumulated, and also on accumulated interest income.[249] In the case of distributed interest income, the liability to withhold tax is on a paying agent.[250] Different tax rates are applied depending on the underlying income types of the distribution. As regards the dividend portion, a withholding tax (KapSt) at the rate of 20 per cent will be levied.[251] On the interest portion, a withholding tax (ZASt) at the rate of 30 per cent will be levied. A withholding tax is not levied insofar as the distribution comprises capital gains or other types of income which are generally exempted from withholding taxes.

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[243] For the new system, see Kußmaul – Beckmann (2001); Bogenschutz – Wright (2000b).
[244] Tibo (2000) 2291.
[245] InvStG § 11(2), which corresponds to KAGG § 38(2).
[246] Stotz (1998) 116.
[247] InvStG § 4(4).
[248] See Stotz (1998) 137-139.
[249] InvStG §§ 7(3)-(4), which correspond to KAGG §§ 38b, 39b and 44.
[250] InvStG § 7(1)-(2). In case only a part of interest income is distributed and the rest accumulated, the withholding tax must be levied on the total amount.
[251] See Tibo (2000) 2291. The rate of withholding tax on dividends was reduced from 25 per cent to 20 per cent by the Tax Reduction Act effective from 2001.

3.5 France

The French approach to the taxation of investment income is based on the principle that tax neutrality should be achieved to the fullest extent between direct investments and investments through French investment funds. In order to achieve this aim, a French investment fund, whether the SICAV or FCP, is treated as a transparent entity. Income arising within an investment fund is taxed exclusively in the hands of underlying investors as if they had made the investments directly and not through an investment fund.[252]

Both the SICAV and FCP are exempt from tax on income derived from the management of their portfolios, irrespective of the character (current income or capital gains) and source (domestic or foreign) of the received income. For the SICAV, the exemption from corporate income tax is expressly provided in Article 208(1) bis A of the CGI (*Code général des impôts*, Tax Code). As regards the FCP, the exemption from corporate tax is a consequence of the absence of legal personality. Although not expressly stated in the law, the tax exemption of FCPs has nevertheless been confirmed by the tax authorities. While exempted from tax, FCPs are considered as 'groups of persons' which from a tax point of view are considered to constitute an entity. However, exemption of capital gains made by the FCP only applies to the extent that no individual holds directly, or through interposed persons, more than 10 per cent of the units of the FCP. [253]

Tax exemption of French investment funds is applied even though the fund elects to accumulate all or part of the income within the fund, rather than distributing it to underlying investors.[254]

Owing to tax exemption, French investment funds cannot benefit from French *avoir fiscal* or foreign tax credits attached to the received income. However, since they are transparent entities, they may transfer tax credits related to income to their underlying investors, under certain conditions, and subject to certain limitations.[255]

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[252] See Blanluet – Portier, Investment Funds, 51.
[253] See Blanluet – Portier, Investment Funds, 51.
[254] Prior to 29 September 1989, French investment funds were required to distribute their earnings to underlying investors.
[255] Blanluet – Portier, Investment Funds, 51-52.

3.6 Finland

Despite the fact that the Finnish investment fund, *viz. sijoitusrahasto*, is not considered as a legal entity under civil law, it is regarded as a corporation for tax purposes.[256] As a result, the investment fund is treated as a separate taxable entity with its own income and wealth separate from the underlying investors. However, the TVL (*Tuloverolaki*, Income Tax Act) expressly exempts the investment fund from income tax[257] and the VVL (*Varallisuusverolaki*, Net Wealth Taxation Act) from wealth tax[258]. This means that all the income – including capital gains, dividends, interest income and any other income, as well as any assets – are not taxable at the investment fund level. The purpose of the tax exemption granted to the Finnish investment fund is to provide neutral tax treatment between direct and intermediated portfolio investments.[259]

According to the transparency principle, all the income is taxed only at the level of underlying investors. Nevertheless, the Finnish tax regime does not follow strict transparency. Firstly, neither the SijRL nor the TVL require the investment fund to distribute its income to unit-holders yearly.[260] Rather, the income may be accumulated within the fund without tax consequences. Secondly, in the case of a distribution, the underlying items of income do not retain their character but the distribution is reclassified as a profit share, *viz. voitto-osuus*. This follows from the treatment of the Finnish investment fund as a separate taxable entity.

The harmful consequence of the tax-exempt status has been that the Finnish investment fund is not entitled to an imputation credit, *viz. yhtiöveronhyvitys*, normally attached to a dividend distributed by a Finnish company.[261] Under the so-called full imputation system which is applied in Finland, the amount of imputation credit corresponds to the amount of tax paid by the distributing company on the distributed income. An imputation credit is then creditable against the resident shareholder's personal tax liability on the dividend income.

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[256] TVL § 3(1)(4).
[257] TVL § 20(1)(2).
[258] VVL § 5(1).
[259] See Andersson – Linnakangas (2002) 146; Andersson (1994) 28.
[260] This has not always been the case. The previous Act on investment funds (*Sijoitusrahastolaki* of 1987) required the fund to distribute to its unit-holders at least half of the amount of the profit of the accounting period, and of other distributable equity deducted by any loss carried forward. See Vapaavuori (1992) 132.
[261] See YHL § 2, according to which the YHL will not be applied to tax-exempted corporations. It may however be noted that the fact that an overwhelming majority of income received by Finnish investment funds is in the form of capital gains rather than dividends reduces the significance of imputation credits for investment funds. See Suomen Sijoitusrahastoyhdistys (2002), according to which, of the assets held by Finnish investment funds, only some 10 per cent are being invested in shares of Finnish companies.

As a result, there is generally no further tax payable on domestic dividends at the resident shareholder level. While the investment fund itself is not eligible to benefit from imputation credit, neither is it possible to transfer the credit to underlying investors. This is because, in terms of taxation, the investment fund, rather than underlying unit-holders, is the beneficial owner of the dividend.[262] As a result, Finnish investment funds have had an incentive to avoid receiving dividends from resident companies by selling shares prior to the ex-dividend day.[263] In any case, the current imputation credit system will be abolished effective from 2005[264], so that the issue of uncreditable imputation credits will lose its significance.

Although the Finnish investment fund is comprehensively exempted from taxes in Finland, it may be liable to tax on its foreign-source income in the source state of income. In Finland, double taxation of foreign-source income is alleviated under tax treaty provisions and the rules of the MenetelmäL (*Laki kansainvälisen kaksinkertaisen verotuksen poistamisesta*, Act on Elimination of International Double Taxation). However, tax credit for foreign taxes is not granted to the investment fund due to the absence of any tax liability against which such taxes could be credited.[265] This holds true even if the investment fund were entitled to foreign tax credits under a tax treaty.[266]

Finally, the management company must withhold a final tax of 29 per cent[267] on distributions made by the Finnish investment fund to its investors. The tax is also applicable to non-resident investors but is subject to tax treaty provisions.[268]

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[262] See Vapaavuori (1998b) 491. In principle, it would be possible to create a system where imputation credits are transferred to underlying investors. Nonetheless, such a system was regarded as extremely complicated and was not adopted. See Andersson (1994) 29.

[263] See Liljeblom (2003) 42.

[264] See HE 92/2004. The background for the abolition is the request submitted by the Finnish Supreme Administrative Court (KHO) to the ECJ on the compatibility of the Finnish imputation tax system with Community law (KHO:2002:56). In addition, a working group set up by the Finnish Ministry of Finance recommends the abolition of the system. See Ministry of Finance (2002), 77-94. For the pressure to abolish or change the Finnish imputation tax system, see Helminen (2001a); Andersson (2001).

[265] See Andersson – Linnakangas (2002) 146; Heiniö (1997) 413; Andersson (1994) 28.

[266] This applies, of course, not only to Finnish investment funds but also other tax-exempt entities.

[267] From 2005, the tax rate for capital income will decrease to 28 per cent.

[268] See Chapter 5.5.3.

3.7 Luxembourg

The Law of 20 December 2002 and the Law of 30 March 1988 not only constitute the legal framework for Luxembourg investment funds but also define the applicable tax regime (Articles 127-131 of the Law of 20 December 2002 and Articles 105-109 of the Law of 30 March 1988). For Luxembourg tax purposes, it makes no difference whether the fund is established in the form of the FCP or SICAV.

Based on Article 127(1) of the Law of 20 December 2002 and Article 105(1) of the Law of 30 March 1988, both the FCP and SICAV are exempt from all taxes apart from the registration duty levied on the contribution of capital and the subscription tax. The second paragraph of the same article exempts also the distributions made by Luxembourg funds from tax at source. In addition, with respect to non-resident investors of Luxembourg funds, it is stated expressly that distributions from Luxembourg funds are not taxable in Luxembourg.[269]

The registration duty (or capital duty), *viz. droit d'apport*, at €1 250 is payable on the formation of a Luxembourg fund whether the FCP[270] or SICAV. The registration duty is payable only once and no further amounts are payable on any subsequent increases in capital.[271]

In addition to the registration duty, Luxembourg funds are subject to the annual subscription tax, *viz. taxe d'abonnement*, at the standard rate of 0,05 per cent per annum[272] in proportion to the net assets of the fund at the end of each quarter. However, funds investing in money market instruments and bank deposits are subject to a reduced rate of 0,01 per cent. In addition, the subscription tax has been abolished for the net assets which have been invested in another Luxembourg fund, provided that the latter is subject to the subscription tax on its assets.[273] Essentially, the subscription tax is comparable to a net wealth tax, being due irrespective of the financial result of the fund.[274]

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[269] Art. 127(2) of the Law of 20 December 2002 and Art. 105(2) of the Law of 30 March 1988. For Luxembourg's tax regime from a perspective of a non-resident investor, see Richter (1995) 489-490.

[270] Since the FCP is not regarded as a legal entity, it would not be subject to any taxes as such. More precisely, it is not the FCP which is subject to the registration duty but rather its management company. Nevertheless, in practice it is commonly agreed that the registration duty is paid from the assets of the FCP.

[271] Art. 128(1) of the Law of 20 December 2002 and Art. 106 of the Law of 30 March 1988.

[272] As of January 2002, the rate was reduced from 0,06 to 0,05 per cent. See Höfer (2002) 371.

[273] The reduced rates are applied separately to each sub-fund of an umbrella fund. See Art. 129(1)-(2) of the Law of 20 December 2002 and Art. 108 of the Law of 30 March 1988.

[274] See Beltjens, Investment Funds, 49-50; Winandy et. al. (1997) 593-594. The subscription tax has been considered to be harmful to Luxembourg as a domicile for investment funds, given that such tax does not exist in competing jurisdictions such as Ireland. See ALFI Statistics Committee (1999) 1.

As income tax exempted entities, Luxembourg investment funds are not entitled to local or foreign tax credits.[275]

In view of the Luxembourg's favorable tax regime for investment fund business, it may be noted that the taxation of management and advisory companies plays an important role. For tax purposes, an FCP and its management company are regarded as a single economic entity which is subject only to the annual subscription tax. Consequently, the management company is not liable to tax on management fees paid by the FCP it manages.[276] This favorable tax treatment is applied only to those management companies which administer one Luxembourg fund, whereas those administering more than one Luxembourg fund are subject to the normal tax regime.[277] As the SICAV need not a separate management company to carry out its transactions, there are no separate tax rules concerning management companies of SICAVs.[278] Instead of a management company, a SICAV often uses the services of a Luxembourg advisory company. An advisory company may opt for the status of a Luxembourg holding company established under the Law of 1929, and hence be exempt from income and net wealth taxes, including withholding taxes. It is subject only to the annual subscription tax of 0,2 per cent on capital and the registration duty of 1 per cent on new capital subscribed. In order to be eligible for holding company status, the advisory company may provide services to only one SICAV.[279]

3.8 Conclusions with a Comparative Survey of Other Member States

The preceding sections show a variety of regimes adopted by the Member States when taxing investment funds. Only the United Kingdom subjects domestic investment funds to income taxes. The other Member States treat their investment funds either as taxable entities which are nevertheless not subject to tax (Germany, France (SICAV), Finland, Luxembourg (SICAV)), or investment funds are not considered as taxable entities at all (France (FCP), Luxembourg (FCP)).

Of the other Member States, The Netherlands applies a model where all investment funds are subject to corporation tax, but at a special rate of 0 per cent, provided that they distribute the net investment income in full within 8

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[275] Beltjens, Investment Funds, 49.

[276] The tax regime applied to management companies in Luxembourg is included in the list of potentially preferential tax regimes by the OECD. The list includes also the tax regime applied to fund managers in the International Financial Services Centre of Ireland. See Vegh (2000) 393 (Appendix I).

[277] See Winandy et al. (1997) 595; Steichen (1989) 83.

[278] KPMG, Funds and Fund Management 2003/Luxembourg, 6.0.

[279] KPMG, Funds and Fund Management 2003/Luxembourg, 6.0.

months of the end of each financial year. However, capital gains do not need to be distributed.[280] In Belgium, the SICAV is subject to a standard corporation tax, but on a reduced tax base. The tax base covers only so-called abnormal and gratuitous advantages, with the consequence that the taxable income is practically nil.[281] Irish investment funds are not chargeable to tax on their own income or gains, but they are obliged to withhold a tax, in respect of a gain arising on a 'chargeable event', to resident investors.[282] In Sweden, domestic investment funds are formally subject to tax on the investment income excluding capital gains, but in practice seldom pay any tax due to the dividend-deduction method. In accordance with this method, distributions paid to investors are deductible from the tax base, so that the tax base can be reduced to nil by way of distributions. Nonetheless, the tax base must be increased by an amount corresponding to 1,5 per cent of the value of securities held by the investment fund.[283]

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[280] See de Jong – Vink, Investment Funds, 86-87. To enjoy the beneficial tax treatment, qualifying investment funds also must meet a number of other conditions.
[281] See Koen, Investment Funds, 50 and Ballon (1997) 295.
[282] See McDermott – McKenna, Investment Funds, 53. A distribution to, and a redemption of units, by the investor constitutes such a chargeable event.
[283] See Gunne (1997) 782-784; Österman (2003) 214.

4 TAXATION OF INVESTMENTS MADE BY INVESTMENT FUNDS IN THE SOURCE STATE OF INCOME

4.1 Introduction

Investment funds generally hold in their portfolio a variety of securities on the basis of which they receive income. In terms of investment policy, some investment funds may concentrate on domestic securities, whereas others may invest only in foreign securities. Yet most investment funds are unlikely to restrict their investments strictly to either domestic or foreign securities, but rather are likely to have in their portfolio a mix of domestic and foreign securities.

Generally, there has been a notable trend towards cross-border investments[284].[285] In the first place, this is because of an increasing awareness of the benefits of international diversification in terms of a better risk and return relationship.[286] It has also become easier for securities to be held across national borders due to the abolition of exchange controls, as well as to deregulation and integration of financial markets.[287] Particularly within the European Union, the common currency euro and developments towards the single financial market have made financial markets of Member States more accessible to investors from other Member States, and in many cases abolished currency risk, which used to be an inevitable part of cross-border investment considerations.

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[284] With respect to a cross-border investment, it is useful to make a distinction between a direct investment and portfolio investment. Typically, in a direct investment the investor is interested in acquiring a substantial interest in the capital or voting rights of a company and thus becoming involved in the management of the company. The main purpose of a portfolio investment is to receive income and capital gains based on the investment, without actively participating in the management of the company. See Easson (1999) 2. The distinction is of course very general in its nature. The concepts both of a direct investment and of portfolio investment may be given very different specific definitions depending on the context in which they are used. See, for example, Helminen (1999a) 21-42. For the concept of portfolio investment, see also Vapaavuori (1991) 1 and 17. The distinction for tax purposes between a direct and portfolio investment should not be confused with the distinction made in economic terms between direct, *viz.* non-intermediated, investment and indirect, *viz.* intermediated, investment.

[285] See OECD (1999) 22.

[286] See OECD (1999) 23.

[287] See OECD (1999) 23.

Most cross-border portfolio investment activity involves the use of financial intermediaries such as investment funds. The extensive use of intermediaries results from the advantages arising from the economies of scale and professional management, which are underscored in cross-border activity. This is because a cross-border investment generally is associated with higher costs[288] and a need for more sophisticated knowledge than is a domestic investment. As a result, it is usually beneficial for an individual investor to make a cross-border investment with the help of an investment fund.

Owing to the economic rationale of using an investment fund as a means of a cross-border investment, it is widely acknowledged that the tax treatment of direct and intermediated cross-border investments should be neutral. In other words, the interposition of the investment fund should not substantially change the tax burden from what it would have been if the investor had invested directly.[289] Any difference between the tax treatment of an intermediated and direct investment could cause a distortion in the investor's choice between them, in favor of the alternative with the higher post-tax rate of return, irrespective of pre-tax rates of returns on investment.

An individual investor's possibility of choice between direct and intermediated investments is likely to differ on a case by case basis. How close a substitute a direct investment is for an intermediated investment may depend, for example, on the amount of financial resources and the degree of knowledge of the investor. Nevertheless, it may be presumed that a direct investment and an intermediated investment are closer substitutes, in a purely domestic context, than in the case of a cross-border investment, owing to the greater financial resources and the more sophisticated knowledge required in the latter case. It follows that, in a case where there are tax disadvantages linked to an intermediated investment, the disadvantage in the form of a lower *post*-tax rate of return related thereto would have to be borne by ordinary investors with moderate resources. Of course, neutral tax treatment of cross-border investments is also desirable from the perspective of an investment fund. Should the tax treatment of cross-border investments be more disadvantageous in terms of tax treatment, as compared to a corresponding domestic investment, the fund would have an incentive to prefer domestic investments to cross-border investments, in view of higher returns.

In the following sections, the taxation of investments made by investment funds in the source state of income will be examined. First, the question will be briefly discussed, from a source state's point of view, of how domestic investment funds are taxed on their investments. Subsequently, the discussion

[288] For example, brokerage and custody fees.
[289] See Ed – Bongaarts (1997) 40 and 42.

will turn to the taxation of cross-border investments made by foreign investment funds in the source state of income. A major part of the discussion concerns the applicability of tax treaties to investment funds from the perspective of the source state. An alternative, of applying tax treaties in the source state of income to underlying investors of an investment fund, will also be considered. Finally, country practices on applying tax treaties in the case of investments made by investment funds are explored.

4.2 Taxation of Domestic Investment Funds

In case the investment fund is resident in the same state where the income arises, only domestic tax law of the state concerned must be considered. As discussed in the previous chapter, domestic investment funds are typically subject to specific tax rules which aim, to a greater or lesser extent, to neutralize the tax impact of the investment fund as between the investor and underlying investments. The taxation of income at source generally follows the general tax regime governing domestic investment funds and therefore does not pose any particular issues.

In the United Kingdom, domestic investment funds are generally taxed under the principles applicable to investment companies. As there is no withholding tax on dividends paid out by UK companies, UK investment funds also receive domestic-source dividends in gross. Withholding tax at a rate of 20 per cent is levied on certain types of interest income[290], in which case the UK investment fund is subject to such tax unless a specific exemption applies.[291] Should the UK fund be subject to withholding tax, such tax is creditable against the corporate tax liability, or is deductible as expense for corporate tax purposes.[292]

In the other Member States, tax-exempted investment funds are typically either not subject to withholding taxes – if any – levied at source (France, Finland, Luxembourg)[293], or at least are refunded any tax withheld at source (Germany)[294]. Here an interesting reference may be made to the Belgian tax model, applied to its non-corporate investment funds which are treated as

[290] See European Tax Handbook 2003, 678.
[291] See Smith – Turner, Investment Funds, 65.
[292] See Smith – Turner, Investment Funds, 65.
[293] It is understood that the comprehensive tax-exemption applies also to any domestic withholding taxes.
[294] In Germany, the exemption from withholding taxes requires the German fund to submit a certificate confirming its status as a tax-exempt entity. In case the fund has not applied for an exemption from withholding taxes, the taxes levied are refundable on application. See Wiesenbart, Investment Funds, 56-58.

transparent – whereby a withholding tax is levied on Belgian-source income when paid *to* investment funds but no longer when the income is paid to underlying investors by investment funds.[295]

4.3 Taxation of Foreign Investment Funds

Taxation issues arising in the context of cross-border investments are as a rule far more complex than in domestic investments. This is due to the fact that not only does the investor's state of residence have the taxing right on income, but also the source state, *viz*. the state where the income arises, may be entitled to exercise its right to tax income on investment received by the non-resident investor.[296]

For tax purposes, jurisdictions distinguish, in their domestic tax legislation, between residents and non-residents. While resident persons are subject to tax on their worldwide income ('unlimited tax liability'), non-resident persons are subject to tax only on income arising within the sources of the state in question ('limited tax liability'). The scope and extent of limited tax liability in the source state depends principally on two issues. First, only the type of income which is determined as being derived from the sources within the concerned state may be taxed. Second, the source state may waive its taxing right on the income, either unilaterally under national tax law or bilaterally through tax treaties.[297] Within the European Union, the Member States have also given up their taxing right in the capacity of source states, with respect to certain items of income, under secondary Community law.

The taxation of the income of foreign investment funds covered by this study in the source state generally takes the form of a withholding tax, because they are treated as portfolio investors for tax purposes in the source state of income.[298] The taxation of portfolio income depends on the type of income received by the non-resident investor. As a general rule, withholding tax is levied on dividend and interest income received by a non-resident portfolio investor, whereas capital gains from securities usually are not subject to tax at source. As regards interest income, many countries have taken unilateral measures to exempt this from withholding taxes, when it relates to certain instruments – in particular on bonds issued by the governments – and when it

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[295] For further details, see Koen, Investment Funds, 53.
[296] See Vapaavuori (1991) 3.
[297] Niskakangas (1983) 48-49.
[298] As stated in Chapter 1.2, it is presumed for the purposes of the study that the activity carried on in the source state by the investment fund does not constitute a permanent establishment. In the case of a permanent establishment, the taxation is usually made by way of an assessment.

is paid to a non-resident investor. Whether income received on the basis of derivative instruments is subject to a withholding tax in the source state of income depends crucially upon which type of income it will be classified as for tax purposes.[299] The following table summarizes the statutory rates of withholding taxes on dividend and interest income under national tax laws of selected states.

Table 1. Statutory Rates of Withholding Tax in Selected States as of 2003.[300]

State	Dividend (%)	Interest (%)
Germany	20[301]	0
Finland	29	0
France	25	0
Ireland	0	0
Luxembourg	20	(15)[302]
Netherlands	25	0
Sweden	30	0
UK	0	0
US	30	0-30

Despite that fact that the income would be taxable in the source state under national tax law, attention must be paid to the tax treaty concluded between

[299] OECD (1998b) 11, defines a derivative instrument as a contractual right that derives its value from the value of something else – such as debt security, equity, commodity or an index. Examples of derivative instruments are forwards, futures, options and swaps. Taxation of income on derivative instruments may involve classification issues, which must be left outside the scope of this study.
[300] Source: European Tax Handbook 2003.
[301] The rate including the 5,5 per cent solidarity surcharge is 21,1 per cent.
[302] From 1.1.2005 as a result of the Savings Tax Directive. See Chapter 6.3.2 of the study.

the source state of income and the residence state of the investor.[303] In accordance with the OECD Model Convention, dividend and interest income may be taxed in both the contracting states, whereas capital gains on securities are taxable only in the residence state of the investor. With respect to portfolio dividend and interest income, the withholding tax that may be imposed is limited to 15 per cent[304] and 10 per cent[305] respectively. As a result, from the perspective of an investor, the application of a tax treaty would usually result in a reduced rate of a withholding tax on dividend and interest in the source state, combined with a relief in the residence state for the tax paid in the source state.[306] As regards capital gains on securities, the exclusive right to tax under a tax treaty belongs to the state of residence, so that no tax is imposed in the source state of income.[307]

Tax treaties generally do not prescribe the way in which the reduction of withholding tax, as provided for under a tax treaty, is to be made. Depending on the source state in question, either of the following two procedures may be applied.[308] Under the refund procedure, the source state levies withholding tax at the full statutory rate, the non-resident investor being thereafter entitled to claim relief, based on the applicable tax treaty, from the source state's tax authorities.[309] Alternatively, a reduced withholding tax rate based on the applicable tax treaty may be applied already at source.[310] The condition for applying a reduced rate at source is usually the submission of the appropriate residence certificate to the payer of income or the relevant paying agent.

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[303] Tax treaties can only restrict a state's right to impose tax on income. The actual right to tax must be based on domestic tax law. See Lindencrona (1992) 125; Sundgren (1992) 284.
[304] Art. 10(2)(b) of the OECD Model Convention.
[305] Art. 11(2) of the OECD Model Convention.
[306] Art. 23(A-B) of the OECD Model Convention.
[307] Art. 13(4) of the OECD Model Convention. As the tax treatment of the different types of income differs in each case, the classification of income plays a significant role. This holds true especially in respect of portfolio investments, owing to rapid innovation of new financial instruments. Thus, before the income may be taxed, a determination must be made as to which type of income it constitutes under the law of the source state. Furthermore, in the tax treaty situation, another classification must be made for tax treaty purposes. This may lead to classification conflicts, as the definitions of income types under domestic tax laws of contracting states may differ or the tax treaty may be interpreted differently. See Vapaavuori (1991) 64-65; Helminen (1999a) 50-53. However, this study will not concern itself with the issues arising from the different income classification.
[308] See Vogel et al. (1997) 570-574.
[309] For example, this generally is the case in Germany, though there are some exceptions. See European Tax Handbook 2003, 237.
[310] For example, this is the case in France, Finland and the United Kingdom. See European Tax Handbook 2003, 213, 193 and 679 respectively.

4.4 Investment Funds and Tax Treaties

4.4.1 General Remarks

From the perspective of the investment fund, tax treaty access would generally have the important consequence of reducing the rate of withholding tax in the source state of income.[311] The reduction of withholding tax in the source state becomes all the more important because most investment funds are not able to credit foreign withholding taxes in their residence state owing to their tax exemption.[312] This holds true, even if the investment fund were in principle entitled to a credit for the remaining withholding taxes in its state of residence under an applicable tax treaty. This is because the right to credit taxes cannot be in practice realized, in the absence of tax liability against which the tax credit could be given.[313] Should the investment fund be exceptionally entitled to a credit for withholding taxes in its residence state, the maximum amount of credit may be limited to the rate of tax provided in the relevant tax treaty, though this may vary between countries.[314] In such a case, taxes levied by the source state of income in excess of tax treaty run the risk of remaining definitive.[315]

In line with the objective of tax neutrality, the interposition of the investment fund should not result in a different tax burden than if the investor had invested directly in the same underlying securities. From the perspective of a source state, the principle of tax neutrality implies that the fund investor should benefit from a tax treaty as if he had received the income directly. In view of the application of tax treaties, a distinction may be made between two different approaches.[316]

In the first place, the treaty access may be conferred on the investment fund itself (*fund access*). In such a case, the principle of tax neutrality implies that, to the extent that the underlying investors of the investment fund would have

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[311] Also, from the perspective of the investor, tax treaty access of the investment fund may be of importance. This is the case when the fund distributes income to a non-resident investor who is subject to withholding tax in the residence state. A reduction of withholding tax on such a distribution under the relevant tax treaty would require the residence state to consider the domestic fund as a tax treaty subject.

[312] See discussion in the preceding Chapter.

[313] Art. 23(1) of the OECD Model Convention provides a rule on maximum deduction which effectively limits the credit in the residence state to that part of the domestic tax which is attributable to the item of income taxed in the source state in accordance with the tax treaty. Therefore, the tax treaty does not oblige the residence state to refund any tax paid in the source state of income. See also Vogel et al. (1997) 1227.

[314] For example, in Finland international double taxation may generally be eliminated more extensively under domestic tax law than is required by tax treaties. See Helminen (2002a) 36. However, this does not apply to investment funds.

[315] See Ed – Bongaarts (1997) 41-42.

[316] Ed – Bongaarts (1997) 43.

access to a relevant tax treaty were the investment made directly, the investment fund should also be regarded as eligible for tax treaty benefits. By the same token, tax treaty benefits should be denied to the extent that there are underlying investors who would not qualify for tax treaty benefits had they invested directly. However, this reverse side of tax neutrality has not always been expressly mentioned.[317] Strictly speaking, in order to achieve full tax neutrality, the applicable tax treaty should be determined on the basis of the residence state of the investor and the source state. However, this would require the source state to treat the investment fund as a transparent entity, and to apply tax treaties at the investor level, which in itself conflicts with the rationale of the fund access.[318]

An alternative approach would therefore be that the eligibility for tax treaty benefits would be determined solely at the level of underlying investors (*investor access*). In other words, the principle of transparency would be followed by the source state when applying tax treaties.

Generally speaking, three main issues arise when considering whether the investment fund itself can be regarded as eligible for tax treaty benefits[319]:

1. Is the investment fund to be regarded as a *person* within the tax treaty meaning?
2. Is the investment fund to be regarded as *resident* within the tax treaty meaning?
3. Is the investment fund to be regarded as the *beneficial owner* of income for tax treaty purposes?

Sometimes there are tax treaty provisions which either specifically address the eligibility, or non-eligibility as the case may be, of the investment fund for tax treaty benefits, or which otherwise indirectly impact on the fund's possibility of benefiting from the tax treaty. However, tax treaties addressing the case of investment funds are in the minority. In the absence of specific provisions, the tax treaty eligibility of an investment fund must be explored under the general rules of tax treaty interpretation.

In the following, some general issues on tax treaty interpretation will first be discussed. Subsequently, the tax treaty eligibility of investment funds will be explored in light of the general conditions of treaty eligibility, as provided

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[317] See, for example, Ed – Bongaarts (1997) 42, stating: "[…] the interposition of a fund should not result in a *higher* tax burden than if the investor had invested directly." (Italics added by the author).

[318] The prerequisite for the investment fund to be eligible for tax treaty benefits in the source state of income is that the latter treats the investment fund as an intransparent entity to which the income is attributed for tax purposes. In case the source state attributes the income directly to underlying investors, the investment fund cannot be eligible for tax treaty benefits, because, from the source state point of view, the investment fund is not the tax subject whose eligibility for tax treaty benefits is under consideration. For this effect see, Züger (2002) 305.

[319] See Ed – Bongaarts (1997) 43; IBFD (1997) 20.

for in the OECD Model Convention. As mentioned earlier, the purpose of the chapter is not to carry out a state-by-state examination of the tax treaties concluded between the selected Member States.[320] Rather, a more general picture of the eligibility of investment funds for benefits under tax treaties following the OECD Model Convention will be provided. However, in Chapter 4.4.4 – dealing with tax treaty provisions addressing specifically the case of investment funds – the focus will naturally be on actual tax treaties. In Chapter 4.4.5 the tax treaty eligibility of underlying investors of the investment fund is explored. The chapter concludes with a review of country practices with respect to tax treaty eligibility of investment funds and their investors.

4.4.2 On Tax Treaty Interpretation

There are no common, internationally-accepted standards for the interpretation of tax treaties. Generally speaking, in the interpretation of tax treaties, the basic sources of interpretation include the Vienna Convention on the Law of Treaties (VCLT), the OECD Model Convention and its Commentaries as well as the tradition of interpreting domestic tax legislation of the contracting state.[321] However, the relative importance of the different sources may vary as between different contracting states. Member States of the EU are also bound by Community law when interpreting and applying tax treaties.[322]

In the first place, as international agreements, the interpretation of tax treaties is governed by the VCLT.[323] The rules of the VCLT are regarded as customary international law, which are used as a basis for interpretation even in those countries that have not ratified the VCLT.[324] According to Article 31(1) of the VCLT a treaty must be interpreted in good faith, in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.[325] The rules of Article 31(1)

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[320] Many tax treaties adher closely to the OECD Model Convention. However, every tax treaty contains some modifications to the OECD Model Convention, because the final form of articles is determined in treaty negotiations between contracting states. Yet, it is convenient to examine the questions arising in the context of tax treaties on the grounds of the OECD Model Convention, in order to give a general overview of the subject. However, in individual cases the wording of the tax treaty in question is decisive rather than that of the OECD Model Convention. See Vogel (1997) 279.

[321] See Helminen (2002a) 21.

[322] See Chapter 7.3.6 of the study.

[323] See Helminen (2002a) 23; Dahlberg (2000) 66; Vogel et al. (1997) 21; Vogel – Prokisch (1993) 66.

[324] See Dahlberg (2000) 66; Vogel et al. (1997) 35.

[325] For a more detailed discussion of the meaning of Art. 31 of the VCLT, see Dahlberg (2000) 68-70; Vogel – Prokisch (1993) 69-74. Moreover, Art. 32 and 33 of the VCLT may be relevant when interpreting tax treaties. Art. 32 of the VCLT confirms the use of supplementary means of interpretation to confirm the meaning of the term derived on the basis of Art. 31, or in exceptional

often are not very different from the way contracting states interpret their domestic laws.[326] Nevertheless, as the rules of interpretation in the VCLT are very general in nature, they are not used as the only means when interpreting tax treaties.[327] In particular, it is often pointed out that the special nature of tax treaties, as a means of allocating tax claims between the contracting states with different tax laws and interests, must be taken into account in the interpretation.[328]

The OECD Model Convention and its Commentaries are in practice an important source of interpretation of tax treaties, not only at the level of taxpayers and tax administrations but also in the courts.[329] However, their legal status and relationship to the VCLT may raise some controversy.[330] The relevance of the OECD Model Convention and its Commentaries are greatest when the other contracting state is also a member of the OECD, when the relevant wording of the tax treaty follows that of the Model Convention, and when no reservations are made by the contracting states to the Commentary in respect of the relevant article.[331] If the wording used in an actual tax treaty differs from that of the OECD Model Convention, the interpretation of the article may also be different from the Model Commentary. However, even in that case it may be considered whether the chosen wording also permits an interpretation consistent with the Model Commentary.[332] Countries also have

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cases, to determine the meaning of the term. According to Art. 33 of the VCLT, different language versions of the treaty have the same value in the interpretation, unless otherwise agreed. For a more detailed discussion, see Dahlberg (2000) 71-73; Vogel et al. (1997) 38-39.

[326] Vogel – Prokisch (2003) 61. For example, this is the case with respect to Finland. See Helminen (2002a) 23.

[327] For example, Finnish courts seldom refer expressly to the VCLT in the interpretation of tax treaties. See Helminen (2002a) 23. However, the principles of interpretation as codified in the VCLT may still impact the solution, although they may not be expressly referred to. Vapaavuori (1993) 320, refers to this impact. The Swedish Supreme Administrative Court (*Regeringsrätten*) has referred expressly to the VCLT in its case law. See Dahlberg (2000) 73-75.

[328] See Helminen (2002a) 21; Vogel et al. (1997) 39; Vapaavuori (1993) 320. According to Vogel et al. (1997) the special nature of tax treaties calls for a common interpretation which is acceptable in both contracting states. Vogel – Prokisch (1993) 61 refer to the fact that a tax treaty can only be effective if it is interpreted and applied in a uniform way. According to Vapaavuori (1993), a more restrictive mode of interpretation is required in the context of tax treaties than in domestic circumstances. It seems that ghe Supreme Administrative Court of Finland (KHO) is also willing to choose the interpretation alternative which results in a more limited taxing right of Finland under a tax treaty. See Helminen (2001b) 79.

[329] See Introduction para. 29.1-29.3 of the OECD Model Commentary. In Germany, the OECD Model Commentary is considered as a very important source of interpretation. See Krabbe (2000) 471 ff.; Vogel et al. (1997) 43. The Supreme Court of Sweden has in its case law expressly confirmed the importance of the OECD Model Commentary as a means of interpreting tax treaties. See Dahlberg (2000) 97-98.

[330] See Vogel et al. (1997) 43-44. For the legal status of the OECD Model Convention and Commentary, see Vogel et al. (1997) 44-45. For the differing opinions on relationship of the OECD Model Convention and its Commentaries to the VCLT, see Dahlberg (2000) 93-94.

[331] See Helminen (2002a) 25.

[332] See Vogel et al. (1997) 45.

the possibility of making reservations on treaty provisions with which they cannot agree.[333] Should the other contracting state have made a reservation in respect of the relevant article, the the OECD Model Commentary is of less relevance.[334]

The OECD Model Convention, and particularly the OECD Model Commentary, have recently been subject to amendments at an ever-increasing rate. This raises the question as to which version of the Model Commentary is relevant when interpreting a tax treaty. In view of the answer to this question, three possible cases may be distinguished.[335] First, where only the OECD Model Commentary, but not the Model Convention, has been amended – with a view to clarifying only the interpretation of the treaty article in question – the revised version of the Model Commentary may be used as a means of interpretation.[336] Secondly, where the interpretation of the relevant article in the OECD Model Commentary has been changed in substance, it is less clear whether the revised version of the OECD Model Commentary may be taken into account in the interpretation.[337] Finally, where the relevant article of the OECD Model Convention has been changed – and, following it, the OECD Model Commentary – after the conclusion of the tax treaty, the revised version of the OECD Model Commentary cannot be used as a means of interpretation with respect to the changed article.[338]

Even if using the same means of interpretation, the contracting states may not agree on the meaning of the term which is used in the tax treaty. In such a case, a conflict of classification may arise, to the extent that it is not clear which of the interpretations should prevail.[339] When applying tax treaties, a conflict of classification arises, either when a tax treaty contains a term from domestic tax law, which will be given their respective interpretations by the residence and the source states; or when the contracting states are able to

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[333] See Introduction para. 31 of the OECD Model Commentary.

[334] In addition to reservations, countries can enter observations in the OECD Model Commentary. Unlike reservations, observations indicate disagreement not with the text of the Model Convention but rather with the interpretation given in the Model Commentary on the article concerned, and they indicate the way in which the country applies the relevant treaty article. See Introduction para. 30 of the OECD Model Commentary.

[335] Dahlberg (2000) 95. There are also other possible approaches. For example, Vogel (2000) 614-616, explores the relationship of amendments in the Model Commentary to the rules of the VCLT.

[336] See Introduction para. 35 of the OECD Model Commentary.

[337] The OECD Model Commentary (Introduction para. 35) does not give a clear answer to this question. For a more detailed discussion, see Dahlberg (2000) 95-96.

[338] This is clearly stated in Introduction para. 35 of the OECD Model Commentary. The effect of changes in the OECD Model Commentary has also been discussed in Avery Jones (2002).

[339] A distinction between an interpretation conflict and a classification conflict must be made, though the distinction may not always be totally clear-cut. See Helminen (1999a) 52-53. In an interpretation conflict, the contracting states define the term differently, despite using the same rules of interpretation. In a classification conflict, the question arises as to which of the possible definitions is to be applied. For conflicts of classification generally, see Stobbe (1989).

interpret the term autonomously.[340] In relation to the former, the OECD Model Convention actually refers to the laws of contracting states when determining the conditions under which a person is to be treated as being resident of the contracting state for tax treaty purposes.[341] In that case, the question arises whether the classification made by the source state or that by the residence state is to prevail. In view of the latter case, the concept 'beneficial owner of income' used in certain treaty provisions is not defined in the OECD Model Convention nor is there any reference to the domestic laws of contracting states.

For the purposes of the interpretation of terms which are used in a tax treaty but not defined therein, the OECD Model Convention provides a general rule of interpretation in Article 3(2). Article 3(2) is a general rule compared to the special tax treaty rules, but a special rule compared to general rules of tax treaty interpretation.[342] It indicates that the definition of the term should be obtained essentially from domestic law, with preference given to the meaning in domestic tax law rather than in non-tax law, unless the context otherwise requires. As a rule, reference may be made to domestic laws in force at the moment of the application of the tax treaty[343], *viz.* ambulatory interpretation, though in the cases of very substantive changes in laws, static interpretation may be required[344]. The application of Article 3(2) may also lead to a different definition of the term between contracting states.[345] The prevailing opinion seems to be that in the case of conflict the definition of the term in the laws of the state applying the tax treaty, *viz. lex fori* classification, prevails.[346] Nonetheless, views have often been expressed, by reference to the requirement of 'unless the context otherwise provides' in Article 3(2), that an independent and uniform interpretation ('autonomous interpretation') of the undefined tax treaty terms should be pursued, prior to resorting to domestic law meanings.[347]

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[340] See Vogel – Prokisch (1993) 82.
[341] Art. 4(1) of the OECD Model Convention.
[342] Vogel et al. (1997) 209.
[343] This is clear from Art. 3(2) para. 11 of the OECD Model Commentary.
[344] This interpretation follows from Art. 3(2) para. 12 of the OECD Model Commentary, which also seems to allow, by reference to the context of the tax treaty, recourse to the laws at the moment of signing. Static interpretation may therefore be necessary if the ambulatory interpretation were to lead to a result which does not correspond to the intention of the contracting states when signing the treaty. Of course, drawing a distinction between minor changes allowing ambulatory interpretation and substantive changes calling for static interpretation may not always be easy. See for a more detailed discussion, Helminen (2002a) 26-27; Dahlberg (2000) 85-86; Vogel – Prokisch (1993) 80-81; IFA (1985) 81-85.
[345] See Vogel – Prokisch (1993) 77. For the interpretation of Art. 3(2), see Vogel – Prokisch (1993) 76-82; Shannon (1989).
[346] See Dahlberg (2000) 86-87; Vogel et al. (1997) 212-213; Vogel – Prokisch (1993) 82-83.
[347] See Helminen (2002a) 26; Vogel – Prokisch (1993) 81-82; Vapaavuori (1991) 65; Niskakangas (1983) 70. It seems that Vogel et al. (1997) 213-216, suggest that *lex fori* classification takes precedence over autonomous classification, though the question should be explored as to whether the context suggests and requires a different interpretation from *lex fori* classification. On the other hand,

A classification conflict does not arise in a case where the term is expressly defined in the tax treaty. In this respect, the OECD Model Convention contains a definition of the term 'person' for tax treaty purposes, unless the context otherwise requires. In such a case, it is clear that the treaty definition will prevail over the domestic definitions of the term, so that no conflict of qualification arises. The definition must be determined in accordance with the general rules of tax treaty interpretation. However, it is still possible that the contracting states do not agree with the definition, as they may interpret the term differently, although without resorting to their domestic laws.[348]

Finally, in view of difficulties arising in the interpretation and application of tax treaties, Article 25(3) of the OECD Model Convention provides that the competent authorities of the contracting states may resort to a so-called mutual agreement procedure in order to find a solution to the conflict.[349]

4.4.3 Tax Treaty Access of Investment Funds

4.4.3.1 Person

According to Article 1, the OECD Model Convention is applied to "persons who are residents of one or both of the Contracting States." Article 3(1)(a) of the OECD Model Convention defines the term 'person' as "including an individual, a company or any other body of persons." While the term 'individual' hardly needs any further explanation here, the term 'company' is further defined in Article 3(1)(b) as "any body corporate or any entity that is treated as a body corporate for tax purposes." The term 'body corporate' refers to any entity that is regarded as a legal person with general legal capacity under the legal system of a state.[350] Consequently, in addition to legal persons, which as such qualify as persons within the meaning of tax treaties, any other entity which is treated as a legal person for tax purposes also qualifies as a person. In view of the latter, the OECD Model Commentary refers to "any other taxable unit that is treated as a body corporate according to the tax laws of the Contracting State in which it is organized."[351] Therefore, any entity, although not being a legal person, also qualifies as a person within the

Helminen (2002a) 26, is of the opinion that the domestic law meaning of the term may be used only if the context does not otherwise require.

[348] See Helminen (1999a) 57-58.

[349] See also Art. 25(3) para. 34 of the OECD Model Commentary. In principle, problems may also be resolved by way of informal negotiations between the competent authorities, which has been the case, for example, in Finland. See for this, Helminen (2001b) 92.

[350] See Vogel et al. (1997) 171-172.

[351] Art. 3(1) para. 3 of the OECD Model Commentary.

meaning of tax treaties if it is treated as a legal person for tax purposes in its state of organization.[352]

The more detailed definition of a body of persons seems to have been left open in the OECD Model Convention and the Commentary. However, according to the OECD Model Commentary, the term 'person' as defined in the OECD Model Convention is not exhaustive and should be understood in a very wide sense.[353] The wide interpretation is highlighted by the amendment to the Model Commentary of 2000, according to which partnerships are to be considered as persons because they constitute bodies of persons, notwithstanding that they may not always fall within the category of a company.[354]

In contrast with its treatment of partnerships, the OECD Model Commentary is silent on the specific question of whether investment funds qualify as persons within the meaning of tax treaties. However, the clarification with regard to the classification of partnerships as persons within the meaning of tax treaties is also useful when considering investment funds, because, to some extent, similar difficulties pertain to both partnerships and investment funds. In both cases, the main difficulty is that while some countries treat partnerships/investment funds as taxable entities under national laws, other countries ignore them for tax purposes by treating them as transparent.[355]

Whether an investment fund constitutes a person, as defined in tax treaties, depends on whether it can satisfy the conditions for qualifying as a company, or alternatively as any other body of persons. This depends essentially on the legal form of the investment fund and, if necessary, on its treatment for tax purposes. It follows that investment funds which take the form of a corporation would readily satisfy the definition of a company, because they constitute legal persons. Furthermore, even if an investment fund were not established as a corporation and therefore would not be a legal person, it could still qualify as a company, provided that it is treated as a legal person for tax purposes. Finally, if an investment fund could not be regarded as a company based on the abovementioned standards, it should still be examined as to whether it could then be included within the meaning of 'any other body of persons' in the same way as partnerships. Consequently, it seems convenient for the purposes of the following discussion that investment funds be divided

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[352] The reference to the state of organization means that the other contracting state must accept the corporate classification of the state of organization of the entity. See Helminen (1999a) 125.
[353] Art. 3(1) para. 2 of the OECD Model Commentary.
[354] See Art. 3(1) para. 2 of the OECD Model Commentary. More specifically, this clarification was inserted into the OECD Model Commentary on 29 April 2000. See OECD (1999a).
[355] However, it must be noted that, unlike partnerships, investment funds may take a variety of different legal forms, which makes the finding of one general solution rather difficult.

into the following three groups on the grounds of their legal character and tax treatment in the state of establishment: 1) corporations, 2) entities without legal personality treated as corporations for tax purposes, 3) other entities not treated as corporations for tax purposes.

Investment funds which are established in the form of a corporation are persons within the meaning of tax treaties. Examples of corporate form investment funds include companies with variable capital, such as the SICAV (Luxembourg and France) and the OEIC (the United Kingdom). The fact that they have a variable share capital rather than a fixed one, should not have impact on the assessment of their corporate nature. In fact, variable capital companies typically are established under the same company law as conventional companies with fixed share capital.[356] The main feature that distinguishes these companies from conventional companies is that their articles of association provide for a variable share capital instead for of a fixed one.[357] A variable share capital is often necessary in order for corporate form investment funds to be able to be open-ended, as required by the UCITS Directive and national investment fund laws.[358]

Apart from investment funds established as corporations, there are investment funds which are not considered as legal persons under civil law, but which are merely based on contractual arrangements between the fund management company, the depositary and underlying investors. Examples of such investment funds include the FCP (Luxembourg and France), the unit trust (the United Kingdom), as well as German and Finnish contractual investment funds. Whether they qualify as persons within the meaning of tax treaties depends on how they are treated for tax purposes in their state of establishment. Should they be treated as a corporation for tax purposes, they would satisfy the conditions of being a company, and thus constitute a person within the meaning of tax treaties. In contrast, in a case where they are not regarded as corporations for tax purposes, it is not readily clear whether the contractual arrangements as such would give rise to a person for tax treaty purposes.[359]

By taking a look at domestic tax legislations, it seems that the UK unit trust, as well as German and Finnish investment funds, are – based on express

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[356] For example, the Luxembourg SICAV adopts the form of a public limited company (*société anonyme*) and is therefore required to comply with the same rules as other companies established under the company law, unless the investment fund law contains derogative rules. The UK OEIC is an exception as it is not established under the conventional UK company law but is a wholly new form of corporate vehicle.

[357] In practice, this is usually made by stating that the amount of share capital must be equal to the net asset value of the company.

[358] More precisely, a variable share capital facilitates continuous issuance and redemption of shares of the investment fund at the net asset value of the fund.

[359] Ed – Bongaarts (1997) 43.

provisions in tax law – treated as corporations for tax purposes.[360] Therefore, they can be regarded as companies and, further, as persons within the meaning of tax treaties.

As far as the French and Luxembourg FCP are concerned, it seems questionable whether they can be included within the definition of a company. Based on the legal form, they are not treated as legal persons for tax purposes, nor are there any specific tax rules which would equate them with entities subject to tax in their state of organization. On the other hand, neither the French nor Luxembourg FCP is completely disregarded for tax purposes. It is, for example, possible to accumulate income in both types of entities.[361] Whether this quality is enough to lead one to the conclusion that these funds are treated as legal persons for tax purposes is somewhat unclear.[362]

In the last resort, however, there remains the possibility for investment funds which do not qualify as companies to claim that they are 'other bodies of persons', and thus that they should be regarded as persons in the sense of tax treaties. The precise meaning of the concept 'other body of persons' has been somewhat unclear and may depend on the jurisdiction in question.[363] It has been argued that investment funds which are considered to be assets held in joint-ownership are not bodies of persons within the treaty definition, unless they are treated as taxable entities.[364] On the other hand, at least France seems to consider that the FCP would fall into this definition and should therefore be treated as a person for tax treaty purposes.[365] This view may partly stem from the broad wording of 'other bodies of persons' in French tax treaties ('*tous autres groupements des personnes*'), which can be understood in a wider sense than the corresponding English wording.[366] However, the OECD Model Commentary also gives support to such a wide interpretation of the notion of a person, by way of including partnerships within the definition. It has also been argued that investment funds, irrespective of their legal forms, should be

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[360] True, with the exception of the UK unit trust, they do not effectively pay taxes under corporate tax laws. However, this is likely to have an impact when considering the residence, within the meaning of tax treaties, of the investment fund rather than its persona. See the following discussion.

[361] The Luxembourg FCP should, in theory, be regarded as a transparent entity so that the income received by it should be taxed annually in the hands of underlying investors. However, in practice, the Luxembourg tax authorities have not followed this approach, but have rather treated investors in the FCP similarly to those of the SICAV, with the consequence that, for example, the accumulation of income in the fund is possible for underlying investors of the FCP. See Winandy (1988) 41 and Winandy et al. (1997) 601.

[362] Cf. Vogel et al. (1997) 172: "Those entities which are treated as bodies corporate for tax purposes are, under Anglo-American law, usually trusts, if all their proceeds are not continually distributed to their beneficiaries."

[363] See Vogel et al. (1997) 173-174.

[364] See Debarre (1992) 387.

[365] See Blanluet (1997) 431.

[366] See Vogel et al. (1997) 173.

regarded as persons for tax treaty purposes.[367] From an economic point of view, it is difficult to find grounds for treating investment funds in different ways, merely on the basis of their legal forms, because the main purpose of any investment fund is to manage assets on behalf of its investors as an independent entity, and irrespective of whether this happens in a corporate or contractual form.

In any case, the notion of a person should not be explored in isolation from the requirement of the person to be also a resident of the contracting state in order to be able to access the tax treaty.

4.4.3.2 Residence

Article 4(1) of the OECD Model Convention defines a resident of a Contracting State as “any person who, under the laws of that state, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature.” Article 4(1) does not provide as such any rule of residence of its own but leaves this to be determined under the domestic tax laws of the contracting states.[368] In the case of a classification conflict over a person’s residence in the other contracting state for tax treaty purposes, the OECD Model Convention does not contain any special rules to resolve the conflict.[369] Therefore, the *lex fori* classification is applicable, whereby both the contracting states may rely on their own domestic tax laws in determining a person’s residence for the purposes of Article 4(1).[370]

To become a resident within the meaning of Article 4(1) of the OECD Model Convention, a person is required to be subject to a comprehensive taxation (full tax liability, unlimited tax liability) in at least one of the contracting states.[371] However, based on the plain wording of Article 4(1), it is somewhat unclear whether or not the notion ‘liable to tax’ in the definition of the term ‘residence’ requires a person to be factually liable to tax on the income. According to one view, it would be sufficient that the person is liable to tax under the general criteria of domestic tax law, irrespective of whether

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[367] Ed – Bongaarts (1997) 53.

[368] See Art. 4 para. 4 and 8 of the OECD Model Commentary. See also Vogel (1996), Art. 4 para. 8; Rivier (1987) 67.

[369] The OECD Model Convention deals only with the situation where a person is a resident of both the contracting states. See Art. 4(2)-(3) of the OECD Model Convention.

[370] See Art. 4 para. 4 of the OECD Model Commentary stating: “[Tax treaties] do not lay down standards which the provisions of the domestic laws on ”residence” have to fulfil in order that claim for full tax liability can be accepted between the Contracting States.” As a consequence, the other contracting state is not obliged to follow the classification of the other state. See also Vogel et al. (1997) 229-230.

[371] See Art. 4(1) para. 8 of the OECD Model Commentary.

any taxes are effectively paid.[372] However, according to a narrower interpretation, it may also be required that the person must effectively pay taxes.[373] This issue seems, to certain extent, to be dependent on a particular language version of the OECD Model Convention. The English wording may be interpreted as requiring that the person be factually liable to tax. However, the wordings used in the Finnish (‘*siellä verovelvollinen*’) and German versions (‘*steuerpflichtig ist*’) seem to require only that the person be regarded as a person subject to tax, but not that the person actually has to pay tax.[374]

In view of the notion of ‘liable to tax’, the OECD Model Commentary on Article 4(1) was somewhat clarified in the year 2000.[375] In the first place, the OECD Model Commentary confirms the dissenting views of the contracting states on the question of whether tax-exempted entities can be considered as residents within the meaning of tax treaties. Based on the Commentary, it can be inferred that tax-exempted entities are often considered as residents if the exemption is conditional on entities fulfilling certain requirements imposed by the domestic law[376], though this is not necessarily the case[377].

Despite the discrepancies in the interpretation of the meaning of ‘liable to tax’, there have been only a few court cases dealing with the issue.[378] In Sweden, the Supreme Administrative Court (*Regeringsrätten*) in the ruling RÅ 1996 ref. 84, which dealt with the tax treaty eligibility of a Luxembourg fund management company of an FCP, found that Article 4(1) of the Sweden-Luxembourg tax treaty did not require any actual tax liability, but rather that it was sufficient that a person was in principle subject to tax.[379]

Apart from tax-exempted entities, the OECD Model Commentary also includes reference to partnerships which are disregarded for tax purposes and treated as fiscally transparent in their state of organization.[380] According to the

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[372] See, for example, Vogel et al. (1997) 229.
[373] See, for example, Debarre (1992) 387.
[374] Helminen (1999d) 2163.
[375] Art. 4(1) para. 8.2-8.4 were inserted into the 2000 version of the OECD Model Commentary. See OECD (1999a).
[376] In other words, should the entity not meet the requirements set for tax-exemption, it would actually be required to pay tax. In this respect, the OECD Model Commentary refers to pension funds, charities and other tax-exempted organizations. See Art. 4(1) para. 8.2 of the OECD Model Commentary. Cf. Art. 4(1)(b) of the US Model Convention which provides expressly that legal persons established in a contracting state exclusively for a religious, charitable, educational, scientific or other similar purpose, or to provide pensions to employees, are treated as residents despite their tax-exemption.
[377] See Art. 4 para. 8.3 of the OECD Model Commentary. It may be mentioned that Greece is the only country which has also confirmed her following of this view by inserting an observation on the Commentary.
[378] Apart from the ruling of the Swedish Supreme Administrative Court, the matter has been dealt with by the Supreme Court of Canada. See Dahlberg (2000) 203-209; Fensby (1998) 107-108.
[379] The decision has been commented upon by Dahlberg (2000) 189-202 and (1997a); Sundgren (1997); Fensby (1998).
[380] Art. 4 para. 8.4 of the OECD Model Commentary.

OECD Model Commentary, fiscally transparent partnerships are clearly *not* considered to be liable to tax within the meaning of Article 4(1) of the OECD Model Convention. Instead, in the view of the Commentary, the partners to whom the income flows are liable to tax on the income, and may therefore be considered as residents for tax treaty purposes.[381]

As far as investment funds are concerned, it is regrettable that the OECD Model Commentary fails to address the issue of residency specifically in the context of investment funds.[382] The absence of considerations relating to the residence of investment funds is all the more regrettable since this is the issue which raises the greatest difficulties between contracting states, when dealing with the tax treaty access of investment funds.[383] In the absence of express guidance in the OECD Model Commentary, the question as to whether investment funds can be regarded as residents for tax treaty purposes must be examined in the light of the reasoning adopted by the Model Commentary in respect of tax-exempt entities and partnerships.[384]

In line with the approach taken in the OECD Model Commentary, it is proper to distinguish between three broad categories of investment funds: 1) separately taxable entities which pay tax; 2) separately taxable entities which are tax-exempt, and 3) entities which are transparent for tax purposes.

Investment funds which are treated as separately taxable entities, and which also pay tax on the income, clearly satisfy the condition of being a resident of a contracting state. Of the investment funds covered by this study, only the UK investment funds (with the exception of bond funds) would belong to this category, because of their actual tax liability on foreign-source dividends and on interest income. The same would seem to apply to investment funds which in principle are subject to tax but which only rarely pay tax, owing to the possibility of treating the distributed income as a cost for tax purposes.[385] Of the investment funds covered by this study, such a method is applied only to UK bond funds.[386]

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[381] Therefore, the partners are considered as eligible for claiming tax treaty benefits based on the tax treaty concluded between the source state of income and their states of residence.
[382] As mentioned, one reason for this may be that investment funds form a more heterogeneous group of entities in terms of legal form and tax treatment than charitable organizations or partnerships.
[383] Ed – Bongaarts (1997) 44.
[384] As mentioned earlier, the problems concerning tax treaty access of investment funds are in many ways similar to the case of partnerships. See also OECD (1999a) 7, where it is recognized that many of the principles discussed in the context of partnerships may also apply with respect to other non-corporate entities.
[385] See Ed – Bongaarts (1997) 44 in connection with 38. See also Helminen (1999d) 2163.
[386] Of other countries, at least the United States and Sweden apply the deduction method. For Sweden, see Gunne (1997) 782 ff. For the United States, see Rachofsky et al. (1997) 855 ff. In the case of the deduction method, it would often be difficult, from a source state's point of view, to assess at the moment of payment of income to the investment fund whether or not this actually pays tax on the income. This would result in difficulties with respect to countries applying a reduction of tax rate at source.

Investment funds which are treated as separately taxable entities, but which at the same time are exempted from tax due to special tax provisions, cause further interpretation difficulties. To this category of funds belong at least the Luxembourg SICAV and Finnish investment funds and also, subject to interpretation, the French SICAV and German investment funds[387]. From the comments on tax-exempted entities in the OECD Model Commentary, it seems arguable that many states could consider investment funds falling into this category as residents within the meaning of tax treaties, owing to the fact that tax exemption is conferred only on the investment funds which fulfill certain specified requirements (legal form, risk-spreading, investment policy etc.).[388] However, the source states adhering to the narrower interpretation of the notion of liable to tax are still unlikely to accept the investment funds of this category as being residents when applying tax treaties.

As regards the category of investment funds treated as transparent, this would include at least the Luxembourg and French FCP and, subject to interpretation, also the French SICAV and German investment funds. As noted earlier, the notion of a transparent entity is somewhat ambiguous, and may refer not only to the situation where the income is taxed in the hands of the participants as it accrues to the entity, *viz.* taxation of income on an annual basis, but also where the income flows through the entity without altering its nature. Based on the wording of the OECD Model Commentary, it seems that transparency here refers simply to the disregard of the entity for tax purposes, and the imposition of tax in respect of the income on underlying participants.[389] If this is the correct interpretation, it seems that at least the investment funds, the underlying investors of which are taxed annually on their part of the income, are transparent in the same way as partnerships, and will therefore not be regarded as residents within the meaning of tax treaties. It follows then that the underlying investors of such investment funds are the appropriate persons to claim the benefits of tax treaties concluded between the source state of income and the residence states of investors ('investor access').[390] The consequences and practical difficulties related to the tax treaty access by underlying investors will be discussed in Chapter 4.4.5.

In conclusion, it seems that the method of integrating the taxation of the investment fund and its investors plays a decisive role when assessing the

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[387] The latter may possibly also be considered as transparent entities. See the following discussion.

[388] For example, in Finland tax-exemption is conferred only on investment funds within the meaning of the SijRL.

[389] See the wording of Art. 4 para. 8.4 of the OECD Model Commentary:"Where a State disregards a partnership for tax purposes and treats it as fiscally transparent, taxing the partners on their share of the partnership income[…]".

[390] This is the view stated in Art. 4(1) para. 8.4 of the OECD Model Commentary.

requirement of being a resident within the meaning of tax treaties.[391] Where the integration of taxation takes place at the investor level, the investment fund being itself factually subject to tax, the requirement of residence would be satisfied by the fund. However, where the fund is tax-exempted, the requirement of residence would only be satisfied when the term 'liable to tax' is interpreted in its broader sense. On account of the ambiguous wording used in the OECD Model Convention, it seems that both interpretations may be regarded as a correct application of tax treaties.[392] For transparent investment funds, it seems difficult to fulfill the requirement of residence within the meaning of tax treaties, presuming that the principles adopted in the case of partnerships in the OECD Model Commentary are also applicable to investment funds.

4.4.3.3 Beneficial Ownership

Article 10 (concerning dividends) and Article 11 (concerning interest) of the OECD Model Convention employ the notion of a beneficial owner of the income.[393] In accordance with the articles, the limitation of a withholding tax is available only if the beneficial owner of the income is a resident of the other contracting state. If the recipient of the income cannot also be regarded as the beneficial owner of the income within the meaning of the applicable tax treaty, the limitation of a withholding tax at source may not be applied.[394]

The OECD Model Convention does not define the term 'beneficial owner'. For the terms used but not defined in tax treaties, Article 3(2) of the OECD Model Convention provides a general rule of interpretation according to which reference is to be made to domestic laws of the contracting state. However, Article 3(2) applies only if the context does not require an alternative interpretation.

There is considerable disagreement about the correct interpretation and application of the concept of beneficial ownership for tax treaty purposes.[395] It is clear that the concept of beneficial ownership was introduced in the 1977 version of the OECD Model Convention with a view to combating tax treaty shopping, *viz.* persons obtaining tax treaty benefits which are not available

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[391] Ed – Bongaarts (1997) 45.

[392] See Helminen (1999d) 2163. An overview of the country approaches to the question of the tax treaty access of investment funds as well as their investors will be made in Chapter 4.4.6.

[393] In addition, Art. 12(1) of the OECD Model Convention (concerning royalties) refers to a beneficial owner. However, that article is not of relevance from the perspective of this study.

[394] See Art. 10 para. 12 and Art. 11 para. 8 of the OECD Model Commentary.

[395] See OECD (2003) 30.

directly, by the use of intermediaries.[396] In view of this, the 2003 version of the OECD Model Commentary aims to clarify the meaning of 'the beneficial owner' for tax treaty purposes.[397]

> "The term "beneficial owner" is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance."[398]

The amendment on the Model Commentary confirms the view that the concept of a beneficial owner should have an autonomous tax treaty meaning distinct from its meaning in the domestic law of the contracting state.[399] Often, the domestic laws of states do not even recognize, or at least do not define, the meaning of a beneficial owner.[400] In line with the principles of tax treaty interpretation, the ordinary meaning of the term 'beneficial owner' should in principle be derived from the plain wording. However, the differing translations (*bénéficiaire effectif, Nutzungsberechtigter)* make it difficult to find an autonomous tax treaty meaning of beneficial ownership based on the plain wording.[401]

In the following, the meaning of 'the beneficial owner' for tax treaty purposes is explored in the light of the amendments on the 2003 version of the OECD Model Commentary. It is not possible to find an exhaustive meaning of the beneficial owner within the limits of this study.[402] Rather, it seems sufficient to explore the circumstances under which investment funds possibly may or may not be considered as a beneficial owner of the income they receive.

Unlike the earlier Commentary, which merely referred to intermediaries, such as an agent[403] or nominee[404], as examples of recipients who may not be

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[396] Art. 1 para. 8-10 of OECD Model Commentary. See also Vogel et al. (1997) 561. Prior to its use in the OECD Model Convention, the concept of a beneficial owner was found in some tax treaties concluded by the United Kingdom, though in a different context.

[397] Art. 10 para. 12-12.2 and Art. 11 para. 8-8.2 of the OECD Model Commentary.

[398] Art. 10 para. 12 of the OECD Model Commentary, and similarly in Art. 11 para. 8.

[399] See also IFA (1998) 15 ff; Vogel et al. (1997) 562.

[400] See Oliver et al. (2000) 313; Vogel et al. (1997) 562. Du Toit (1999) 207, considers that the fact that the concept of beneficial ownership is used in tax treaties, even by the states whose domestic law does not recognize the concept, confirms its having an autonomous tax treaty meaning. Apart from the United Kingdom, the Netherlands included recently the beneficial ownership test in its national tax law, in connection with its dividend-stripping rules. See Helminen (2002a) 454-455. An autonomous tax treaty meaning may also be advocated by the consideration that it would contribute to a more uniform interpretation and application of tax treaties between contracting states. See Ryynänen (2003) 349.

[401] Oliver et al. (2000) 311-312. In Finland, the corresponding term used in some tax treaties refers to a person who has a right to the income and in some other treaties to a person who is the owner of income. See for this, Ryynänen (2003) 351-352.

[402] Such an attempt is made by du Toit (1999).

[403] An agent generally refers to a person who is authorized to act on behalf of another person.

considered as beneficial owners of the income[405], the 2003 version of the OECD Model Commentary intends to clarify the meaning by means of somewhat more comprehensive examples.

> "Where an item of income is received by a resident of a Contracting State acting in the capacity of agent or nominee, it would be inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption merely on account of the status of the immediate recipient of the income as a resident of the other Contracting State. The immediate recipient of the income in this situation qualifies as a resident but no potential double taxation arises as a consequence of that status since the recipient is not treated as the owner of the income for tax purposes in the State of residence."[406]

Interestingly, the OECD Model Commentary now clearly refers to the issue of whether the recipient of income is treated as the owner of the income for *tax purposes* in the residence state. Prior to the clarification, it was considered somewhat unclear to what extent the attribution of income for tax purposes in the residence state of a person plays a role, when determining the beneficial owner of the income.[407] However, in the US treaty practice, it has been understood that the beneficial owner refers to the person to whom the residence state attributes the income for tax purposes.[408]

> "It would be equally inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption where a resident of a Contracting State, otherwise than through an agency or nominee relationship, simply acts as a conduit for another person who in fact receives the benefit of the income concerned. For these reasons, the report from the Committee on Fiscal Affairs entitled "Double Taxation Conventions and the Use of Conduit Companies" concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter,

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[404] A nominee is, according to the IBFD International Tax Glossary, the legal owner of property holding it on behalf of the beneficial owner.

[405] See, for example, Art. 10 para. 12 of the 2000 OECD Model Commentary stating: "[…] the limitation of tax in the State of source is not available when an intermediary, such as an agent or nominee, is interposed between the beneficiary and the payer […]". From that clarification, it was widely concluded that the beneficial owner test was not only restricted to the cases of agents or nominees, but could also apply to other similar intermediaries interposed between the beneficiary and the payer. See, for example, du Toit (1999) 216.

[406] Art. 10 para. 12.1 and Art. 11 para. 8.1 of the OECD Model Commentary.

[407] See, for example, Ryynänen (2003) 357, who argues that the concept of a beneficial owner does not as such require the person to be subject to tax on the income received, in order to qualify as a beneficial owner, though this often is the case.

[408] See Art. 10 para. 2 of the Technical Explanation of the US Model Convention. See also OECD (1999a) para. 61, where participants of a transparent partnership are considered as beneficial owners of the income, due to the fact that they are the persons liable to tax on such income in their state of residence.

> very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties."[409]

Based on the above clarification, it can be concluded that an analysis of the nature and extent of *rights* and *obligations*, in respect of the received income retained by the respective parties, should be made in order to determine to which party the beneficial ownership should or should not be attributed.[410] Beneficial ownership would generally be lost when an intermediary has a legal obligation to transfer the income onwards to another person.[411] On the other hand, if an intermediary is free to decide on the use of the income paid to it, the person could generally be considered as the beneficial owner of the income. Based on the above, it seems that the ownership of the assets yielding the income is not, as such, of relevance when determining the beneficial ownership of the income. It may be said that the concept of beneficial ownership concerns itself with the ownership of the income paid and does not necessarily require the beneficial owner of the income to be also the beneficial owner of the assets yielding the income. Nonetheless, the ownership of the assets may of course be helpful in also indicating the beneficial owner of the income.[412]

From the point of view of investment funds, the question arises as to whether they will satisfy the condition of being the beneficial owner of the income paid. If the answer to this question is negative, it must also be determined who is/are the beneficial owner(s) of the income for tax treaty purposes.

It is clear that an investment fund, in accordance with its legal and economic purpose, acts as an intermediary between the underlying investors and final investments, but that it is not generally considered as an agent or a nominee in legal terms.[413] However, according to the revised comments on the term beneficial owner, it seems that further analysis is needed, in order to establish whether or not the investment fund may qualify as a beneficial owner of the income it receives for tax treaty purposes. Obviously, there are two different starting points for such an examination. In the first place, the tax treatment of the investment fund in the residence state must be explored. In the

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[409] Art. 10 para. 12.1 and Art. 11 para. 8.1 of the OECD Model Commentary.

[410] Ryynänen (2003) 355.

[411] Ryynänen (2003) 355.

[412] See Ryynänen (2003) 358. Cf. also Vogel et al. (1997) 562, who consider that the beneficial owner is "he who is free to decide (1) whether or not the capital or other assets should be used or made available for use by others or (2) on how the yields there from should be used or (3) both". It seems, based on the wording of the OECD Model Commentary, that the power to decide on how the yields are used takes precedence over other attributes of ownership.

[413] See Ed – Bongaarts (1997) 54, who directly conclude that the investment fund will be the beneficial owner since it is the person to whom the income is paid and is not an agent or a nominee.

second place, an analysis of the nature and extent of rights and obligations in respect of the received income retained by the investment fund, on the one hand, and by investors, on the other, must be made.

The 2003 version of the OECD Model Commentary clearly suggests that the question of beneficial ownership may be linked to the tax treatment of the income in the residence state.[414] In this respect, the wording used in the Commentary ("*no potential double taxation* arises as a consequence of that status since the recipient is not treated as *the owner of the income for tax purposes* in the State of residence")[415] is, however, not entirely clear. If the decisive matter when examining beneficial ownership is whether or not potential double taxation arises in respect of the income in the residence state of a recipient, it seems that tax-exempted investment funds can hardly ever be regarded as beneficial owners of income. In this case, the beneficial ownership test would come close to the 'subject to tax' test.[416] On the other hand, if the focus is placed merely on who is the owner of the income for tax purposes – without regard to actual tax liability – even tax-exempted investment funds could qualify as beneficial owners of income to the extent that they are intransparent for tax purposes.[417] However, it seems also that compulsory redistribution rules ('deemed distribution'), imposed by the tax laws of some states, could be regarded as an indication of the investment fund not being the beneficial owner of the income it receives for tax purposes.[418]

The 2003 version of the OECD Model Commentary also invites a more delicate analysis of the nature and extent of the legal rights and obligations retained by the participants in respect of the paid income when determining the beneficial owner.[419] Generally speaking, the utilization of the received

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[414] See also Ed – Bongaarts (1997) 45.
[415] Italics added by the author.
[416] According to Vogel et al. (1997) the OECD Committee on Fiscal Affairs originally considered making treaty benefits dependent on the paid income being subject to tax in the state of residence. However, due to difficulties arising concerning the right allocation of income, the Committee decided in favor of the concept of a beneficial owner. See also Ryynänen (2003) 357, who states: "Conceptually, the denotation of beneficial ownership does not require that the item is inevitably subject to tax in the hands of the recipient in his state of residence. But generally speaking, a beneficial owner usually refers to a person resident in a contracting state to whom that state attributes the payment for purposes of its tax." It is also arguable that the investment fund not actually liable to tax on the income would already fail to satisfy the residence test, without the need to consider its status as the beneficial owner in respect of the paid income.
[417] In the case of intransparent entities, the underlying participants clearly are not to be regarded as the owners of income for tax purposes.
[418] See Ed – Bongaarts (1997) 46. In such a case, the income, i.e. dividend and interest, are taxed annually in the hands of underlying investors, at least to the extent that these are residents in the same state as the investment fund.
[419] As concluded earlier, the ownership of assets is secondary in view of determining the beneficial owner of the income, though it may be a useful indication. See also Ed – Bongaarts 45-46, who refer to the fact that investment funds lacking legal personality may be more suspect, in relation to qualifying as beneficial owners of income, since they cannot own the assets by themselves. The assets

income will be determined in the fund rules by the fund management company, within the limits of relevant laws. It is clear that what has been stipulated in the fund's rules, regarding the utilization of the income yielded from the assets under management, generally does constitute a legal obligation for the investment fund, or for the fund management company acting on its behalf, as far as the utilization of income is concerned. On the other hand, the fund rules are also binding on the underlying investors. For example, by subscribing units which do not have the right to a distribution from the investment fund, the investor has agreed not to receive a distribution of income from the investment fund. In contrast, by subscribing units which do entitle the investor to a distribution of income, the investment fund is obliged to pay such a distribution under the terms agreed in the fund's rules. At least in this latter case, it seems that the beneficial owner of the income may be regarded as being the underlying investor rather than the investment fund.

If the treaty benefits are denied to the investment fund because, it is not considered to be the beneficial owner of the income, the treaty benefits should then be conferred on the underlying investors, which are regarded as beneficial owners.[420] For the sake of clarity, it must be mentioned that the fund management company clearly cannot be regarded as the beneficial owner of income.[421] Although the management company of an investment fund without a legal personality has the legal right to deal with the property of the investment fund on behalf of the fund, it would be wrong to claim it to be the beneficial owner of the income. The income will benefit the management company only to the extent that it increases the net assets of the fund, on the basis of which the management company is entitled to charge a management fee for the services rendered to the investment fund. While the management fee is generally taxable income for the fund management company, the income received from the source state is not attributed to the management company for taxation purposes, but to the investment fund – or its investors – on whose account only the first-mentioned receives the income.[422]

In sum, it must be acknowledged that the question as to whether the investment fund or its investors are to be regarded as the beneficial owner of income is subject to interpretation and cannot be fully answered. After all, this

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of contractual form investment funds are generally legally considered to be co-owned by the underlying investors rather than by the investment fund itself. To make things more complicated, the 'real' control over the assets does not generally belong either to the investment fund or to its underlying investors, but to the fund management company which acts on behalf of the investment fund and the investors.

[420] See Art. 10 para. 12.2 and Art. 11 para. 8.2 of the OECD Model Commentary.

[421] Similarly Blanluet (1997) 434.

[422] There are however cases where source state tax authorities have accepted claims for tax treaty benefits by the management company *(Kapitalanlagegesellshaft)* of a German investment fund. See Wiesenbart, Investment Funds, 77.

is likely to depend largely on the specific circumstances of each case.[423] It seems that there are arguments both for and against treating the investment fund itself as the beneficial owner of the income it receives. The control over the income yielded by the assets may, depending on the stipulations in the fund rules, be considered to belong either to the investment fund or to its investors. In the end, the question as to who is to be regarded as the beneficial owner of income may perhaps only be answered by balancing the ownership attributes of the participants against each other. It is suggested that the beneficial owner would then be the person whose ownership attributes outweigh that of any other.[424] Moreover, the tax treatment of the income in the residence state of the recipient may also play a role in the investigation. From a pragmatic perspective, it may, however, be noted that it is unlikely that the tax authorities in the source state would carry out such an extensive investigation.[425]

As far as the investments covered by this study are concerned, it may be suggested *de lege ferenda* that there is, for the most part, altogether *sufficient* beneficial ownership attributable to the investment fund for it to be legitimately considered as the beneficial owner of the income, without the need to resort to the burdensome comparison of ownership attributes between the investment fund and its investors.[426] Treating the investment funds covered by this study as the beneficial owners of income would not be in conflict with the purpose of the beneficial ownership, *viz.* preventing the improper use of tax treaties. In most cases, tax treaty benefits would be more easily available to investors by way of a direct investment in the same underlying securities. Moreover, to the extent that underlying investors were resident in the same state as the investment fund, tax treaty benefits would in any case be available, irrespective of whether the investment fund or its investors are regarded as the beneficial owner of the income.

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[423] See OECD (2003) 29.

[424] See du Toit (1999) 237 and Ryynänen (2003) 361.

[425] For the problem of evidence when investigating the beneficial owner of the income, see Ryynänen (2003) 364.

[426] This is not to say that in certain cases the ownership attributes of underlying investors would not exceed those of the investment fund. It is merely that the investment fund may be considered as the beneficial owner within the limits of the meaning of the concept as determined above. The question as to whether underlying investors of the investment fund could be regarded as ’more legitimate’ beneficial owners of the income is thereby left open.

4.4.3.4 Limitation of Benefits

Even though the investment fund would meet the conditions of being a resident person of the contracting state and the beneficial owner of the income it receives, attention must be paid to any possible 'limitation-of-benefits' provisions[427] in the tax treaty and their impact on the investment fund.[428] In the 2003 version of the OECD Model Commentary, a variety of provisions aimed at limiting the benefits of tax treaties were introduced.[429] There has also been an increasing tendency among the countries to insert such provisions in tax treaties.[430]

Under tax treaties, being a resident person of one or both of the contracting states is the decisive factor when determining a person's entitlement to benefits of the relevant tax treaty. However, in certain situations, it is considered necessary to exclude a person from some or all of the benefits otherwise conferred by a tax treaty, despite that person qualifying as a resident of a contracting state. The OECD Model Commentary refers to such situations generally as improper use of the convention.[431] The improper use of the convention as understood in the OECD Model Commentary is a wide concept thereby covering a wide variety of cases. However, most often improper use of the convention involves the problem of treaty shopping. Treaty shopping refers to arrangements aimed principally at obtaining the benefits of a tax treaty which would not otherwise be applicable to the taxpayer because he is not a resident of a contracting state.[432]

Although it is obvious that the investment funds covered by this study cannot be established principally for treaty shopping purposes[433], they may nevertheless share some common features with the entities used for such purposes. In particular, the facts that investment funds are to a greater or lesser extent owned by non-resident investors, and are exempted from taxes in their residence state, invite a closer investigation of the impact of limitation-of-benefits provisions on investment funds. In the following, three types of limitation-of-benefits provision are considered:

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[427] The use of the beneficial ownership test also aims to limit the available tax treaty benefits. See Art. 1 para. 10 of the OECD Model Commentary.
[428] Domestic anti-avoidance rules, which also in some cases may have an impact on the person's right to tax treaty benefits, are not discussed here. See Art. 1 para. 9.1 et seq. of the OECD Model Commentary.
[429] See OECD (2003) 13.
[430] Arnold – Dibout (2001) 76.
[431] Art. 1 para. 7 et seq. of the OECD Model Commentary.
[432] Vogel et al. (1997) 119. For treaty-shopping constructions, see Ginsberg (1994) 6-8; Küsell (1998) 217.
[433] As mentioned in Chapter 1, the fact that investment funds covered by this study are widely owned and cannot be controlled by any party of investors make it virtually impossible to use them for abusive purposes.

1. limitation-on-benefits provision;
2. exclusion provisions;
3. subject-to-tax provisions.

Limitation-on-benefits provision. Limitation-on-benefits provisions have long been an established part of US tax treaty practice.[434] The 2003 version of the OECD Model Commentary, for the first time, also deals with such a provision as a comprehensive means of preventing treaty shopping.[435] Presently, all the tax treaties concluded by the US with those states of central interest for the purposes of this study contain such a provision.[436] Consequently, it has to be examined when the eligibility of investment funds for reduced withholding tax rates on income (particularly dividends) derived from the US is considered.[437] The importance of the matter is underscored by the fact that investments made into the US financial market play an important role in the portfolios of European investment funds.

The purpose of the limitation-on-benefits provision is to prevent persons who are not residents of either contracting states from accessing the benefits of a tax treaty through the use of an entity that otherwise qualifies as a resident of the contracting state.[438] The general theory underlying the limitation-on-benefits provision is that the contracting state grants tax treaty benefits to a resident entity of a contracting state only in cases where the latter also has sufficient business or some other legitimate nexus with the other contracting state.[439] The mere fact that an entity is treated as a resident of the other contracting state is not, as such, sufficient to entitle the entity to tax treaty benefits.

The limitation-on-benefits provision works by limiting tax treaty benefits to the residents who are so-called qualified persons[440] as defined in several different categories.[441] Should the person not fall into the one of the designated categories of qualified persons, he would not be eligible for tax treaty benefits, despite being nominally treated as a resident person for tax treaty purposes:[442]

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[434] See Technical Explanation to Art. 22 of the US Model Convention.
[435] Art. 1 para. 20 of the OECD Model Commentary.
[436] See Art. 16 of the US-UK tax treaty; Art. 28 of the US-Germany tax treaty; Art. 16 of the US-Finland tax treaty; Art. 30 of the US-France tax treaty. The current US-UK tax treaty contains a limitation-on-benefits article of a very limited scope. However, the new US-UK tax treaty will contain an extended limitation-on-benefits provision. See Cussons (2000) 84-85.
[437] The limitation-on-benefits provision is a two-way provision affecting also US investment funds.
[438] Art. 1 para. 20 of the OECD Model Commentary. See also Technical Explanation to Art. 22 of the US Model Convention.
[439] See Technical Explanation to Art. 22 of the US Model Convention.
[440] See Art. 22(1) of the US Model Convention.
[441] Art. 22(2)(a-f) of the US Model Convention.
[442] Limitation-on-benefits provisions in US tax treaties differ in their details, but the following is a typical example of such a provision. See Rachofsky et al. (1997) 863-864. The example provided here also corresponds closely to the one in the OECD Model Commentary.

a) individuals who are residents of a contracting state;
b) contracting states and other political subdivisions thereof;
c) certain tax-exempt entities that are owned by a requisite number of qualified residents;
d) persons resident in a contracting state if
i) more than 50 per cent of the beneficial ownership interest in the persons are owned by US citizens or by qualified residents described in items (a), (b), (c) or (e) and
ii) less than 50 per cent of the person's gross income is paid out to non-residents in the form of interest, royalties or other deductible payments;
e) resident companies the shares of which are substantially and regularly traded on one or more recognized exchanges in either contracting state;
f) resident entities that are engaged in an active business in the residence state if the income derived from the other state is derived in connection with or incidental to that business;
g) persons obtaining a favorable ruling from the competent authority.

Of the categories of qualified persons, an investment fund may possibly rely on one of the following categories: d) (hereinafter 'ownership and base erosion test'), e) ('quoted company test'), or g) ('subjective test').[443] Notably, the limitation-on-benefits provision does not generally make difference between entities organized for investment purposes and those organized for other purposes.[444]

The most straightforward way for an investment fund to be a qualified person would be to satisfy the 'quoted company test' (e).[445] However, this test is generally suitable only for closed-end funds, the shares of which often are traded on a stock exchange.[446] By contrast, open-end funds typically are only exceptionally traded on a stock exchange, which makes the test practically useless for most open-end funds. Since the aim of the quoted company test is to allow tax treaty benefits for widely-held entities that cannot be dominated by any party for treaty-shopping purposes, it seems inconsistent that investment funds not publicly-listed cannot rely on the test.[447] It is arguable

[443] Item c) usually refers to pension funds, charities and other similar non-profit organizations. Cf. Art. 23(2)(f) of the US-Ireland tax treaty; Art. 27 ("exempt organizations") of the US-Germany tax treaty; Art. 16(1)(f) of the US-Finland tax treaty. Consequently, it is not applicable to investment funds. Item f) 'active business test' is not applicable because making and managing investments do not qualify as active business unless these activities are carried on by a bank, insurance company or registered securities dealer. See Art. 22(3)(b) of the US Model Convention.
[444] Newberry et al., Investment Funds, 170.
[445] For details, see Technical Explanation to Art. 22(2)(c)(i) of the US Model Convention.
[446] For example, the UK investment trust company (ITC) is a closed-end investment company whose shares are listed on the London Stock Exchange and which therefore can rely on the quoted company test. See Smith – Turner, Investment Funds, 110-112.
[447] See Rachofsky et al. (1997) 864-865.

that the obligation of open-end investment funds to issue and redeem the units at the request of investors constitutes a sufficient guarantee of their not being available for treaty shopping purposes in the same way as publicly traded companies.[448]

Given the virtual impossibility of most open-end funds meeting the quoted company test, the so-called 'ownership and base erosion test' (d) must be considered. It consists of two stages, both of which have to be satisfied. First, the ownership requirement prescribes that at least 50 per cent of the beneficial interest of the entity be owned, directly or indirectly, either by qualified persons within the meaning of the limitation-on-benefits provision or by those who are US citizens, for at least half the days of the taxable year. Second, the base erosion test prescribes that less than 50 per cent of the entity's gross income for the taxable year be paid out to non-resident persons in the form of interest, royalties or other deductible payments.[449] With respect to open-end funds, both the tests create interpretation and compliance problems.[450] Firstly, the percentage of units owned by qualifying residents fluctuates continuously due to the subscription and redemption of units by investors, so that in borderline cases it would be difficult to determine whether a fund satisfies the ownership test. Secondly, in the case of investment funds with sub-funds or various share classes, it is somewhat unclear whether the ownership test is applied to each sub-fund or share class separately, or to the investment fund as a whole.[451] Tax treaties are often unclear as to the period over which to determine ownership. Thirdly, investment funds subject to the dividend-deduction method[452] may fail to satisfy the requirement if the major part of distributions is paid to non-resident investors.[453] Finally, the problem of submitting the evidence needed to comply, particularly with the ownership test, may pose problems for investment funds.

Finally, a limitation-on-benefits provision usually provides the competent authorities with discretionary powers to allow tax treaty benefits despite the person's failing to be treated as a qualified person (g). The subjective test could be used as a last resort, in circumstances where the establishment and operations of an entity would not have, as one of the principal purposes, the obtaining of benefits under the treaty.[454] Despite the fact that it is in practice

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[448] See Kronat (2001) 201-202.
[449] For further details, see Technical Explanation to Art. 22(2)(f) of the US Model Convention.
[450] Rachofsky et al. (1997) 865.
[451] Newberry et al., Investment Funds, 170, suggest that the test is applied to each class of beneficial interests in the entity.
[452] For example, bond funds in the United Kingdom.
[453] Ed – Bongaarts (1997) 49.
[454] Technical Explanation to the Art. 22 para. 4 of the US Model Convention.states:"This discretionary provision is included in recognition of the fact that, with the increasing scope and diversity of international economic relations, there may be cases where significant participation by

unclear as to when discretionary powers may be applied[455], it may not be unreasonable to expect that investment funds covered by this study could qualify for treaty benefits based on the subjective test.[456]

In sum, it seems that the limitation-on-benefits provision is liable to have impact on investment funds whose units are mainly held by non-resident investors, such as Luxembourg funds.[457] However, in most cases, it is unlikely that the proportion of non-resident investors in an investment fund could exceed the 50 per cent threshold, or the major part of distributions be paid to such investors. Nevertheless, the application of the limitation-on-benefits provision may cause compliance problems on the side of investment funds, as well as uncertainty with regard to the availability of tax treaty benefits under US tax treaties.

Exclusion provisions. The second category of the limitation-of-benefits provisions examined in this study consists of exclusion provisions.[458] An exclusion provision, by definition, excludes certain entities as specified in the provision from the scope of the tax treaty. The traditional example of such a provision is the exclusion of Luxembourg holding companies established under the tax regime of 1929 (the Law of 31 July 1929) which is found in the majority of tax treaties concluded with Luxembourg.[459] Given the importance of Luxembourg funds as a means of cross-border investments, it is only appropriate to consider the impact of exclusion provisions in light of tax treaties concluded with Luxembourg.[460]

The scope of the holding company exclusion is crucially dependent on the particular wording used in the provision.[461] In this respect, there exist two kinds of exclusion clause. Some Luxembourg tax treaties specifically address holding companies within the meaning of the special Luxembourg regimes governed by the Law of 31 July 1929 (so-called ‘1929 holding companies’) and the Grand-Ducal Order of 17 December 1938 (so-called ‘billionaire holding companies’). This type of specific holding company clause is

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third country residents in an enterprise of a Contracting State is warranted by sound business practice or long-standing business structures and does not necessarily indicate a motive of attempting to derive unintended Convention benefits.” See also Walsh (1997) 389.

[455] See Debatin – Endres (1990), Art. 28 para. 30-31. For some clarification of this issue, see Muntendam (1996) 394-395.

[456] See also Kronat (2001) 203, for the possibilities of German investment funds to qualify for treaty benefits based on the subjective test under the US-Germany tax treaty.

[457] See Ed – Bongaarts (1997) 48.

[458] Art. 1 para. 21-21.2 of the OECD Model Commentary refers to ’the exclusion approach’ in the context of ’provisions which are aimed at entities benefiting from preferential tax regimes.’

[459] The two exceptions are the tax treaties concluded with China and Romania. See Muntendam (1996) 386 footnote 1.

[460] In the following, only the SICAV is considered. The FCP is in any case often ineligible for tax treaty benefits due to its legal form.

[461] Beltjens, Investment Funds, 63.

generally interpreted as being confined to the expressly mentioned types of holding companies.[462] Consequently, it would not exclude the Luxembourg SICAV from the scope of the tax treaty.

In addition to provisions excluding specific holding companies, there are exclusion clauses which are drafted to cover holding companies governed not only by the abovementioned laws, but also by any other similar law enacted by Luxembourg after signing the treaty.[463] Despite its broad wording, it is considered that this type of exclusion clause cannot be applied to investment funds. This is supported by the fact that the investment funds cannot be regarded as holding companies: the purpose of a holding company is the acquisition of substantial participations, whereas an investment fund may not acquire substantial participations given its status and purpose.[464] On the other hand, it seems that some tax authorities may consider this type of clause to be applicable even to the Luxembourg SICAV, owing to the similarity of tax benefits accorded to holding companies and investment funds under the relevant Luxembourg laws.[465]

Apart from the two types of holding company exclusions, some Luxembourg tax treaties contain more wide-ranging exclusions which also address other companies enjoying substantially similar tax benefits to holding companies under the Luxembourg laws. Based on the wording, this type of exclusion clearly is not restricted to holding companies, and may lead to the exclusion of the Luxembourg SICAV from the scope of the tax treaty. The specific scope of the exclusion will, as a rule, be determined by the competent authorities. It seems that in several cases the general exclusion clause will be applicable to Luxembourg investment funds. Of the EU Member States, only the tax treaty between Luxembourg and Greece contains a general exclusion clause[466].[467]

Subject to tax provisions. The final type of limitation-of-benefits provision to be considered is the subject-to-tax clause.[468] It restricts the tax treaty benefits to income which is subject to effective taxation in the beneficial

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[462] This type of holding company exclusion is used in Luxembourg tax treaties with, among others,. Austria, Denmark, Finland, France, Germany, the Netherlands, Norway, Spain and Sweden.

[463] This type of holding clause is inserted in Luxembourg tax treaties with, among others, Belgium, Ireland and the United Kingdom.

[464] Beltjens, Investment Funds, 64. See also Winandy et al. (1997) 608.

[465] See Winandy et al. (1997) 607.

[466] The exclusion of Luxembourg investment funds under this exclusion clause has been confirmed in the parliamentary proceedings relating to the treaty. See Beltjens, Investment Funds, 64.

[467] The protocol to the Sweden-Luxembourg tax treaty also contains a general exclusion clause. However, this exclusion clause also refers expressly to Luxembourg investment funds. See Dahlberg (2000) 248-250. For a survey of different types of holding company clause in Luxembourg tax treaties and for the attitude towards the treaty access of the SICAV of different tax treaty partners, see the table in Winandy et al. (1997) 609.

[468] Subject-to-tax provisions are dealt with in Art. 1 para. 15-16 of the OECD Model Commentary.

owner's residence state. The France–Luxembourg treaty contains such a provision, thereby making the tax treaty practically inapplicable to Luxembourg, as well as French, investment funds on account of their tax exemption.[469] As a rule, subject-to-tax provisions would result in the denial of tax treaty benefits with respect to investment funds, because the income generally is not subject to tax in the hands of investment funds. However, they are generally not widely used in tax treaties concluded EU Member States.[470]

4.4.4 Specific Provisions Concerning Investment Funds

Some tax treaties contain specific provisions concerning investment funds, but they are in minority.[471] On the other hand, it is notable that the number of tax treaties with specific provisions dealing with investment funds has been steadily increasing.[472]

Specific provisions concerning investment funds fall broadly into two categories.[473] In the first place, there are provisions which deal with the tax treaty eligibility of investment funds, or alternatively their investors. Secondly, there are provisions which address the classification of distributions from investment funds for tax treaty purposes.[474] The purpose of specific provisions is to clarify in advance difficulties encountered in the interpretation and application of tax treaties to investment funds, or to their distributions. In the following, only the provisions falling into the former category of provisions are dealt with. For the purposes of the following discussion, it is useful to distinguish between three types of provision[475]:

1. exclusion of investment funds;
2. inclusion of investment funds;
3. tax treaty benefits by reference to qualifying investors, as specified, of the investment fund.

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[469] Beltjens, Investment Funds, 62.
[470] Another example of the subject-to-tax provision is found in the United Kingdom-Israel tax treaty, which requires that the capital gain realized by the person must also be subject to tax in the residence state of the person in order for the source state to waive its taxing right on such gains. See Smith – Turner, Investment Funds, 113.
[471] Ed – Bongaarts (1997) 43.
[472] Ed – Bongaarts (1997) 48.
[473] See Ed – Bongaarts (1997) 48 and 50.
[474] It has been the practice of Germany to specify the classification of income from investment funds in her tax treaties. See Chapter 4.4.6 dealing with Germany.
[475] Note that the agreements on the position of investment funds between contracting states do not always take the form of provisions, but may also be agreed on by way of a protocol or exchange of letters.

Exclusion of investment funds. Some contracting states may wish to agree expressly on the exclusion of investment funds from the scope of the tax treaty. Nevertheless, it seems that this is not a common practice, the examples of such exclusions apparently being of concern to Luxembourg investment funds, particularly the SICAV,[476] only Sweden having expressly denied access from all investment funds governed by the Law of 30 March 1988, *viz.* the SICAV and FCP, in its tax treaty of 1996 with Luxembourg.[477]

Inclusion of investment funds. There are also examples of contracting states wishing expressly to include investment funds, as specified, within the scope of the tax treaty. It has been notably the treaty practice of the United States to clarify the residence of investment funds for tax treaty purposes in its recently concluded treaties.[478] For example, the tax treaty concluded between the United States and France in 1996 stipulates that the US RIC (Regulated Investment Company) as well as the French SICAV and FCP are to be considered as residents for tax treaty purposes.[479] Similarly, the US-Ireland treaty concluded in 1998 stipulates in the residence article that the US RIC and Irish collective investment undertakings are considered as residents of a contracting state.[480] Nonetheless, the US tax treaty policy has not been consistent, the new US-Sweden treaty, for example, containing no mention of the residence of investment funds within the meaning of the tax treaty.[481] It should also be noted that the importance, for an investment fund, of qualifying as a resident under tax treaties concluded with the United States does not generally guarantee tax treaty benefits because these may still be denied based on the limitation-on-benefits provision.[482]

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[476] As mentioned in the preceding chapter, the SICAV may also be excluded on the grounds of holding company clauses. There are some examples where the competent authorities of Luxembourg and the treaty partner have agreed in advance on the applicability of the general exclusion clause on the Luxembourg SICAV. See Beltjens, Investment Funds, 64.

[477] The specific reference to Luxembourg investment funds is found in the protocol to the treaty. See Dahlberg (2000) 248-250; Sundgren (1997) 381.

[478] See Walsh (1997) 380.

[479] See Art. 4(2)(iii) of the US-France tax treaty.

[480] See Art. 4(1)(d) of the US-Ireland tax treaty. 'Collective Investment Undertaking' in Ireland includes a unit trust, an undertaking for collective investment in transferable securities (UCITS), an investment limited partnership and an investment company. See Walsh (1997) 380. The purpose of including this specific provision concerning investment funds is explained in the Technical Explanation to the US-Ireland treaty as follows:"[the provision] clarifies that certain investment vehicles are residents of the Contracting States in which they are created or organized, even though the tax on the income they derive may be imposed only or primarily at the level of their shareholders, beneficiaries, or owners."

[481] See Art. 4(1) of the US-Sweden tax treaty. Perhaps there was no need for clarification as the tax regime governing investment funds in both countries is based on the so-called dividend-deduction method. As the United States generally considers the RIC as eligible for tax treaty benefits, the same treatment should in principle apply to Swedish investment funds. See also Helminen (1999d) 2165.

[482] See Rachofsky et al. (1997) 861.

Tax treaty benefits by reference to qualifying investors. The contracting states may agree to allow tax treaty benefits to be claimed by the investment fund on behalf of, and by reference to, qualifying underlying investors, as defined. Notably, this has been the tax treaty practice of France and Switzerland in respect of withholding taxes at source, and of France also in respect of a refund of *avoir fiscal.*[483] Both the French and Swiss approaches are based on the view that an investment fund is merely an intermediary between the investment made and the underlying investors, with the consequence that the right to claim treaty benefits actually belongs to underlying investors rather than the fund.[484] The fact that an investment fund is given the right to claim treaty benefits on behalf of its investors is seen purely as a practical arrangement facilitating a more effective claim of tax treaty benefits, which otherwise might be left unclaimed owing to practical difficulties related to the application process by each individual investor. Consequently, the French and Swiss approaches differ in their premises from the US approach, which is based on the direct tax treaty access by the investment fund combined with a limitation-on-benefits provision.[485]

France has a number of tax treaties, containing special provisions or other agreements, allowing French investment funds and funds of the other contracting state to make proportional claims in respect of withholding taxes on dividend and/or interest. [486] The benefits are typically granted proportionally, by reference to the percentage of the underlying investors who are resident in the same state as the investment fund to the total amount of investors, though there are some exceptions[487]. In addition, some French tax treaties provide foreign investment funds with a possibility of applying for a proportional refund of French *avoir fiscal*.[488]

[483] See Ed – Bongaarts (1997) 48-50.
[484] For the French point of view, see Blanluet (1997) 433. For the Swiss point of view, see 'Erstattung von Kapitalertragsteuer an Investmentfonds auf Grund von Doppelbesteuerungsabkommen' (Erlasse FinMin Nordrhein-Westfalen vom 14. Dezember 1964 und 22. Juli 1965 – S 1301 – 27 – VB 1) in Bölter et al. (1996) 206-207.
[485] Therefore, while the French and Swiss approaches are effective only in respect of a refund of withholding taxes or of French *avoir fiscal* in the source state, under the US approach the investment fund may benefit also from other advantages provided for by the tax treaty.
[486] This is the case in the tax treaties concluded by France at least with Austria, Germany, Spain, Sweden, Switzerland and Japan. See Blanluet, Investment Funds, 80-83. As regards Switzerland, this is the case in the tax treaties with at least Germany, France, the Netherlands and Sweden. See Hess – Sigg (1996) 380.
[487] It seems that treaty benefits granted to Spanish investment funds are not subject to this limitation. See Blanluet, Investment Funds, 82.
[488] In addition to the tax treaties mentioned above, a refund of *avoir fiscal* is provided by the French treaties with, among others, Finland, the Netherlands and Norway. In such case, the amount liable to a withholding tax at source is increased by the amount of *avoir fiscal*. See Blanluet, Investment Funds, 80-83.

Nevertheless, the application procedure in respect of proportional tax treaty benefits often involves numerous practical difficulties. Firstly, the fund obviously must be in a position to make a distinction between resident and non-resident underlying investors.[489] While in some cases there is specific guidance as how to make the necessary distinction, this is not always the case. Under the tax treaty between France and the Netherlands, for example, the distinction is to be determined on the basis of distributions paid by the investment fund to resident and non-resident investors respectively.[490] An example of the case where there is no specific guidance is the treaty between France and Germany. Here it seems that the reclaims by German funds are practically precluded by the French tax authorities, which do not accept the way in which German funds determine the proportion of resident investors.[491]

Another issue is how the benefits provided by the tax treaty are shared among the investors. While Swiss funds are allowed to distribute repayments of foreign withholding taxes only to qualifying Swiss residents[492], it seems that, in German funds, benefits are shared with all the investors irrespective of their residence, possibly owing to the absence of any mechanism which would facilitate a distinction based on the residences.[493]

4.4.5 Tax Treaty Access of Underlying Investors

Should the source state of income not consider the investment fund itself as eligible for tax treaty benefits, the possible application of a tax treaty on the level of underlying investors should be examined ('investor access'). Generally speaking, the outcome that the investors' entitlement to tax treaty benefits must be examined may be reached in two ways. In the first place, the source state of income may, under its domestic tax law, classify the foreign investment fund as transparent and attribute the income to the underlying investors of the fund.[494] On the other hand, the source state of income may also deny tax treaty access from the investment fund, on the grounds of the latter's failure to fulfill the requirements of being entitled to tax treaty benefits, *viz.* qualifying as a resident person of the contracting state and the beneficial

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[489] See Hess – Sigg (1996) 380.
[490] See Blanluet, Investment Funds, 84.
[491] See Stotz (1998) 122-123. Moreover, additional difficulties arise for multi-level fund structures such as funds of funds, because investigation of several funds is needed before the ultimate underlying investors can be identified. See Blanluet (1997) 436.
[492] See Hess – Sigg (1996) 380.
[493] The different treatment of underlying resident and non-resident investors is also of interest from the Community law perspective. This issue will be addressed in Chapter 7.6 of the study.
[494] See Züger (2002) 305-306.

owner of the income[495].[496] In addition, tax treaty benefits may be denied on grounds of limitation-of-benefits or exclusion provisions[497], though in such cases it is arguable that the investor access is not to be considered[498]. In the following, the issue of investor access will be dealt with from both theoretical and practical points of view.[499] It is appropriate to distinguish between the case where the investor is resident in the same state as the fund ('two-country case') and the one where the investor is resident in another state than the fund ('triangular case').

Two-country case. Should the source state of income not consider the investment fund to be eligible for tax treaty benefits on account of the latter's transparency, the investor should be eligible for the benefits with respect to his share of the income to the extent that such income is allocated to him for tax purposes[500].[501] However, in the classification conflict between the source state of income and the residence state of the fund, problems may arise. This is the case where the source state classifies the investment fund as transparent, but where the residence state treats the latter as intransparent, thereby not taxing the resident investors on the income.[502] According to the OECD Model Commentary, the source state should take into account the way in which the item of income is treated in the residence state of the person claiming the benefits.[503] However, this is unlikely to resolve the conflict, because the source

[495] In the following discussion, the investment fund is referred to commonly as 'transparent' to the extent it is not entitled to tax treaty benefits, irrespective of whether this results from the classification under domestic tax law as transparent or from the failure to meet the general requirements of tax treaty access. It follows from Art. 1 para. 6.4 of the OECD Model Commentary, with respect to partnerships, that in case the entity fails to be regarded as resident or the beneficial owner of the income for tax treaty purposes, the underlying participant should generally be regarded as the resident and the beneficial owner, provided that the participant meets the conditions. Therefore, in the OECD Commentary's view, even the fact that the investment fund may initially be considered as person for tax treaty purposes but not resident or the beneficial owner of the income does not as such exclude the underlying participant's possibility to access the tax treaty in case the requirements are met by the latter. Cf. Ed – Bongaarts (1997) 56, who state: "Where the fund […] does not fulfil the residence and beneficial ownership criteria it would not be entitled to treaty access […] Whilst in theory this would preclude an investor claiming treaty access by reference to a double taxation treaty between his country of residence and the source country *because the fund would still be a person for treaty purposes,* this benefit is illusory […]" (italics added by the author).

[496] See Chapters 4.4.3.1-4.4.3.3.

[497] See Chapters 4.4.3.4 and 4.4.4.

[498] This is because the investment fund is considered the tax treaty subject which, in principle, is entitled to tax treaty benefits, though, in practice, excluded from the benefits on grounds of provisions aimed at restricting the improper use of the tax treaty. It would be most unlikely that the source state would accept any claims by underlying investors in such cases.

[499] The examination is, for the most part, based on the principles adopted in the OECD Model Commentary with respect to partnerships. See OECD (1999a).

[500] And, it should be added, provided that the requirements for tax treaty access are met by the investor.

[501] Cf. Art. 1 para. 5 of the OECD Model Convention, with respect to partnerships.

[502] Cf. Art. 1 para. 6.2 of the OECD Model Convention, with respect to partnerships.

[503] Cf. Art. 1 para. 6.3 of the OECD Model Commentary, with respect to partnerships.

state is not, in the first place, willing to treat the investment fund as eligible for tax treaty benefits.

Triangular case. Should the source state of income not consider the investment fund to be eligible for tax treaty benefits owing to the latter's transparency, the investor should be eligible for the benefits with respect to his share of the income, to the extent that such income is allocated to him for tax purposes[504]. In a triangular situation, from the perspective of the investor, the applicable tax treaty is that concluded between the source state of income and the residence state of the investor, but not the one with the residence state of the investment fund. Nevertheless, a triangular situation may involve difficulties with respect to the determination of entitlement to benefits under the tax treaty. According to the OECD Model Commentary, the source state should follow the allocation of income not only in the residence state of the investor but also that of the entity.[505] As a result, there generally may arise not only the case of 'double benefits'[506] but also that of 'no-benefits'.

The former would arise insofar as the residence state of the investor allocates the income to him for tax purposes, whilst at the same time, the entity is treated as intransparent in its residence state for tax purposes.[507] However, the case of double benefits is unlikely to exist in the case of investment funds and their investors, because it is not the practice of most states to tax annually the income from investments in foreign investment funds.

The 'no-benefits' case would arise insofar as the entity is treated as transparent in its residence state, and when, at the same time, the income of the entity is not allocated to the investor for tax purposes in his residence state.[508] The case of 'no-benefits' is likely to arise in the case of investment funds with non-resident investors, though not on account of the source state's following the residence state classification, but rather as the result of a classification conflict. In the first place, it is common that the source state denies the tax treaty benefits from the investment fund on grounds of this transparency, despite the fact that, in the view of the residence state, the investment fund is to be treated as intransparent.[509] On the other hand, the investor is often not taxed on the income from the foreign investment fund on

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[504] And, it should be added, provided that the requirements for tax treaty access are met by the investor.

[505] Art. 1 para. 6.5 of the OECD Model Commentary, with respect to partnerships.

[506] This is the term used in Art. 1 para. 6.5 of the OECD Model Commentary. In the case of two applicable tax treaties, the one providing the lower withholding tax rate should, in the view of the Model Commentary, be applied.

[507] As a result, in the view of the Model Commentary, both the investor and the entity are entitled to tax treaty benefits, though of course under a different treaty.

[508] Art. 1 para. 6.5 of the OECD Model Commentary, with respect to partnerships.

[509] See Chapter 4.4.6 of the study.

a yearly basis, in which case the residence state classification readily results in the absence of tax treaty benefits.

Practical considerations. While the approach based on the investor access may be successfully applied to partnerships and their partners[510], it confronts numerous practical problems when applied to open-end investment funds, owing to the distinctive nature of the latter as compared to partnerships. First and foremost, the difficulties arise from the concept of transparency, which is a prerequisite for the tax treaty access of underlying investors. For partnerships the fact that they are transparent is often their essential characteristic for tax purposes.[511] Despite the fact that many national tax laws governing the tax treatment of investment funds are often described as being based on transparency, the extent to which the transparent tax treatment is actually applied varies depending on the perspective from which one considers the matter.[512] As a result, the likelihood that there will arise a classification conflict between contracting states, over the transparent nature of the investment fund in question, is high.

Secondly, the open-end character of investment funds, with a continuously changing investor base, raises the question of the beneficial owner of the income. This problem is linked to the want of transparency of investment funds, as in most countries the income itself is not allocated to the underlying investors – since it is received by the fund – but rather on a distribution, whether actual or deemed, by the fund.[513] Moreover, in the absence of a distribution or in the case of disposal of units, the income would not flow-through to an underlying investor at all. As a result, it is not necessarily clear who is the beneficial owner of the income and thus entitled to claim treaty benefits. Whether the beneficial owner is the investor at the time the income was received by the fund, or at the time a distribution comprising the relevant income was made by the fund, should be determined.[514]

Thirdly, the question must be raised as whether underlying investors are capable of providing the evidence needed to claim treaty benefits.[515] It seems extremely unrealistic to assume that each underlying investor could make

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[510] Even in the case of partnerships, the availability of tax treaty benefits may crucially depend on whether a partner is resident in the same state as the partnership. See Gall (1995) para. 22.
[511] Gall (1995) para. 5. However, even in the context of partnerships, the extent of transparency varies from country to country. See for this, Gall (1995) para. 11-14.
[512] For different dimensions of transparency, see Chapter 3.2. Even in the countries covered by this study the different dimensions of transparency are either present to varying extents and in different combinations, or are totally absent.
[513] Ed – Bongaarts (1997) 47.
[514] Ed – Bongaarts (1997) 47.
[515] It has been frequently reported that individual investors are in practice unable to carry out such claims. Generally, see Ed – Bongaarts (1997) 56. For the United Kingdom, see Smith – Turner, 105. For Sweden, see Gunne (1997) 788. For Japan, see Yamate – Ori, Investment Funds, 104.

claims to the tax authorities of relevant source states, particularly in view of the fact that the amounts of withholding tax refunds allocated per investor are relatively small. However, for practical reasons, it is sometimes possible that aggregated claims be made by an investment fund on behalf of its investors, to the extent that the latter are resident in the same state as the former.[516] In such a case, the investment fund should be able to provide necessary documentation on the proportion of resident investors participating in the fund. In view of non-resident investors in the investment fund, it seems that, as a rule, the benefits under the tax treaties concluded between their residence states and the source state of income are subject to individual claims, either because the source state of income does not accept claims on behalf of non-resident investors, or because it is not practical for the fund to claim such benefits, for the same reasons as it is often unreasonable for individual investors to do so.

In conclusion, it seems obvious that the approach based on the investor access is too difficult to carry out in practice, if it is based on individual claims made by each investor.[517] Theoretically, granting tax treaty benefits directly to underlying investors follows the principle of transparency and should lead to tax neutrality. However, the practical difficulties associated with such an approach will inevitably make the objective of reaching tax neutrality practically unattainable.[518] On the other hand, should the aggregated claims by investment funds on behalf of their investors be accepted by the source state of income, then practical difficulties are diminished and benefits may be claimed to the extent that investors are resident in the same state as the investment fund.

4.4.6 Country Practices

The United Kingdom. Tax treaties concluded by the United Kingdom do not address the tax treaty eligibility of investment funds. The United Kingdom is of the view that the AUT and OEIC are, as a rule, entitled to tax treaty benefits since they are subject to UK tax on their income.[519] Consequently, they should be eligible for reduced withholding tax rates in the source states.[520]

The tax treaty access of foreign investment funds at source will be determined on a case-by-case basis, and will depend on the wording of the applicable tax treaty, and on the legal form and tax treatment of the particular

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[516] For example, this is the case in the Netherlands. See de Jong – Vink, Investment Funds, 123-124.
[517] Ed – Bongaarts (1997) 47.
[518] See also Sorgenfrei (1994) 471.
[519] With the exception of capital gains, which may cause uncertainty as regards the applicability of capital gains provisions of tax treaties to the UK investment funds.
[520] See Smith – Turner, Investment Funds, 110-112.

investment fund. As a general rule, tax treaty access will not be allowed for non-resident investment funds which lack legal personality. The Inland Revenue views, for example, the Luxembourg and French FCP as being transparent for UK tax purposes. Consequently, the availability of treaty benefits will in principle depend on the residence of the underlying investors.[521] The treaty access may also be denied from investment funds with legal personality in cases where these are not liable to tax on income in their state of residence. For example, the Luxembourg and French SICAV are not eligible for tax treaty under the tax treaties concluded with the United Kingdom.[522] Finally, it may be noted that the importance of access to UK tax treaties by non-resident investment funds is often of minor significance, since no withholding tax will be levied on dividends and interest income under the tax laws of the United Kingdom.

Germany. From a German perspective, the tax treaty access of investment funds is not clear. Germany seems to consider German investment funds as eligible for tax treaty benefits.[523] It seems that this would apply at least in cases where the dividend article of the tax treaty equates the profit distribution by the investment fund with a dividend.[524] On the other hand, because of many uncertainties related to tax treaty access on the side of German treaty partners, some bilateral agreements have been concluded which allow tax treaty access only by reference to underlying investors, rather than directly to German investment funds.[525] It seems that many foreign tax authorities deny tax treaty access from German investment funds.[526]

Recently, the German tax authorities have issued guidance as to eligibility of foreign investment funds to claim a refund in respect of source taxes under German tax treaties.[527] It seems that the guidance is based on the view that investment funds established as legal persons are themselves eligible for tax treaty benefits, whereas those considered as transparent are eligible only if all

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[521] See Smith – Turner, Investment Funds, 114.

[522] However, the Belgian SICAV benefits from the tax treaty since it is subject to tax on its income, albeit only nominally. See Smith – Turner, Investment Funds, 113-114; Hurley (1997) 839-840.

[523] Vogel et al. (1997) 107.

[524] Brinkhaus – Scherer (2003) 1548-1549. It has been argued that the refusal to admit tax treaty access to German investment funds would conflict with a tax treaty to the extent that the profit distribution by the investment fund is subjected to the dividend article. See Täske (1997) 461. In this respect, it must also be noted that the wording used in German tax treaties varies significantly, which may raise interpretation difficulties. See Sorgenfrei (1994) 471.

[525] See Vogel et al. (1997) 107. However, this is the case only with France and Switzerland.

[526] See Brinkhaus – Scherer (2003) 1549; Wiesenbart, Investment Funds, 77; Sorgenfrei (1994) 470-471.

[527] See Bundesamt für Finanzen (2002). The guidance deals with the new possibility introduced by the German tax authorities to apply for a refund of taxes electronically. It is divided into two parts, whereof the second one is of relevance in that it indicates the persons who are eligible for claiming a refund. It is notable that so far there has been no published official guidance as to the treaty eligibility of foreign investment funds in Germany.

underlying investors are residing in the same state as the fund. Consequently, the UK OEIC and AUT and the Luxembourg SICAV, for example, are themselves entitled to tax treaty benefits. Conversely, Finnish investment funds are eligible for tax treaty benefits only if all underlying investors are also resident in Finland.[528] French investment funds are, in accordance with the Germany-France tax treaty, eligible for claiming treaty benefits by reference to qualifying underlying investors.[529]

France. The French tax authorities seem to interpret the 'liable to tax' requirement strictly, when determining the residence of foreign investment funds within the meaning of tax treaties, thereby requiring the fund effectively to pay taxes on income in the residence state.[530] In the view of the French tax authorities, the FCP is not considered to be a resident for tax treaty purposes. As regards the SICAV, the position of tax authorities is not totally clear, but it seems that its treaty access is possible.[531] Moreover, it seems that the French tax authorities are reluctant to accept the investment fund as the beneficial owner of income.[532] The French tax authorities have confirmed that the UK investment funds are, owing to their actual tax liability, eligible for tax treaty benefits in the same way as other UK residents.[533] In other cases, the tax treaty benefits are available only to the extent that an applicable tax treaty specifically provides for it. As mentioned earlier, it has been the tax treaty policy of France to negotiate specific arrangements, in order to assist French and foreign investment funds in making proportional claims for refund in respect of withholding taxes, by reference to qualifying underlying investors.[534] The France-US tax treaty also expressly includes both the French and US investment funds in the scope of the tax treaty, though the eligibility for benefits is subject to limitation-on-benefits provision.[535]

Finland. Tax treaties concluded by Finland do not typically contain any reference to the right of investment funds to access treaty benefits.[536] In Finnish tax treaty practice, foreign investment funds have generally been considered to be eligible for tax treaty benefits irrespective of the legal form and factual tax liability in the residence state.[537] This has recently been

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[528] The relevant German wording is "[…] *falls nicht alle Begünstigte/Beteiligte des Investmentfonds in Finnland ansässig sind*." The plain wording seems to exclude proportional claims by reference to resident investors.
[529] See Wiesenbart, Investment Funds, 78.
[530] See Blanluet (1997) 434.
[531] See Blanluet, Investment Funds, 77-78.
[532] See Blanluet (1997) 434.
[533] See Blanluet, Investment Funds, 85.
[534] See Blanluet, Investment Funds, 80 ff.
[535] See Blanluet, Investment Funds, 83.
[536] See Heiniö (1997) 413; Vapaavuori (1999) 330.
[537] Heiniö (1997) 413.

confirmed by two advance rulings by the Central Tax Board. In the first one, a German open-end real estate fund (*offene Immobilienfonds)* established in the form of *Sondervermögen* was considered to be a person eligible for Finland-Germany tax treaty.[538] In its groundings, the Central Tax Board referred to the facts that the German fund was considered as a separate taxable person, despite its tax exemption, for German tax purposes, and that under the TVL (Finnish Income Tax Act) it was considered as a separate tax subject with limited tax liability. The second advance ruling involved a Luxembourg FCP, on the units of which a Finnish limited liability company was to receive income.[539] According to the Central Tax Board, the characters and operations of the FCP were comparable to the Finnish investment fund, so that it is to be treated as a separate taxable person, and not as transparent, for Finnish tax purposes. Therefore, the Finland-Luxembourg tax treaty is applicable to the income received by the Finnish company from the Luxembourg FCP. It seems that foreign investment funds are considered to be tax treaty subjects for the purposes of Finnish tax treaties, at least to the extent that they are treated as separate taxable entities in the residence state or are comparable to the Finnish investment fund. Therefore, the treatment of foreign investment funds for tax treaty purposes in Finland, as a rule, does not differ from that of foreign corporations.

The United States. Some of the more recent tax treaties concluded by the United States specifically prescribe that the US investment funds as well as corresponding funds of the other contracting state are treated as a resident of a contracting state.[540] In other cases, entitlement of investment funds to benefits under US tax treaties will, in the first place, be dependent on whether they satisfy the condition of being a resident person of a contracting state. The 1996 US Model Convention contains an essentially similar definition of a resident person to that of the OECD Model Convention.[541] In the US treaty practice, the entities which are nominally subject to tax, but which in practice rarely pay tax, have generally been treated as residents.[542] As regards US Regulated Investment Companies (RIC), it has been considered that the fact that the RIC is taxable on the part of its undistributed income is enough to satisfy the requirement of it being liable to tax within the meaning of tax treaties.[543] In this respect, the Internal Revenue Service (IRS) has recently released guidance

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[538] KVL 61/2002.
[539] KVL 8/2003. The case has been referred to the Supreme Administrative Court (KHO).
[540] For example, the treaties concluded with Ireland and France. See Chapter 4.4.4.
[541] See Art. 4(1) of the US Model Convention: "[…] resident of a Contracting state means any person, who under the laws of that State, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature."
[542] See Technical Explanation to the US Model Convention, Art. 4 para. 1.
[543] See Technical Explanation to the US Model Convention, Art. 4 para. 1.

(Revenue Ruling 2000-59) on the interpretation of the 'liable to tax' test for US tax treaty purposes.[544] In the view of the IRS, the liable to tax test does not require effective taxation, and thus can be met notwithstanding that an entity is exempted from taxes, although being nominally subject to tax. In addition, however, an 'indication' that the foreign fund is treated as being intransparent for tax purposes in its residence state is required to satisfy the 'liable to tax' requirement. Examples of such an indication would be a levy of a withholding tax on distributions paid to non-resident investors by the fund, or a limited flow-through of income in terms of the income type, *viz.* transformation of income should occur when income is redistributed to underlying investors. Finally, the recognition of the foreign investment fund is subject to reciprocity on the side of the other contracting state, in view of the tax treaty access of US investment funds.[545] In the end, claims by investment funds for tax treaty benefits may also be precluded by the limitation-on-benefits provision.[546]

4.5 Conclusions

The tax treaty access of investment funds is a highly disputable issue. In the first place, this is due to the various possible interpretations given to the terms 'person', 'residence' and 'beneficial owner of income'. In the second place, limitation-of-benefits provisions may restrict access of investment funds to tax treaties. The brief survey of country practices also shows a wide variety of approaches to the tax treaty access of investment funds. The main issues confronted by investment funds when considering tax treaty access in the source state of income are summarized in the following flow chart. A distinction may be made between three main approaches in terms of the eligibility for benefits under tax treaties[547]:

1. full access;
2. partial access;
3. no access.

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[544] Released in Internal Revenue Bulletin (I.R.B.) 2000-52, December 26, 2000. For a summary, see Tax News Service 15.1.2001; Vogel (2001).

[545] According to Revenue Ruling 2000-59, a foreign person is not considered as a resident of a contracting state if one of the next conditions is fulfilled: 1) the treaty partner has announced by public notice that such persons are not residents of that state, 2) there is a competent authority agreement or a specific treaty provision that such persons are not residents of that state, or 3) the treaty partner would not treat similar US persons as residents of the United States, and the IRS has issued a public notice indicating that treaty benefits to such persons are consequently being denied.

[546] Newberry et al., Investment Funds, 169; Rachofsky et al. (1997) 861.

[547] This is the distinction made by Ed – Bongaarts (1997) 52 ff.

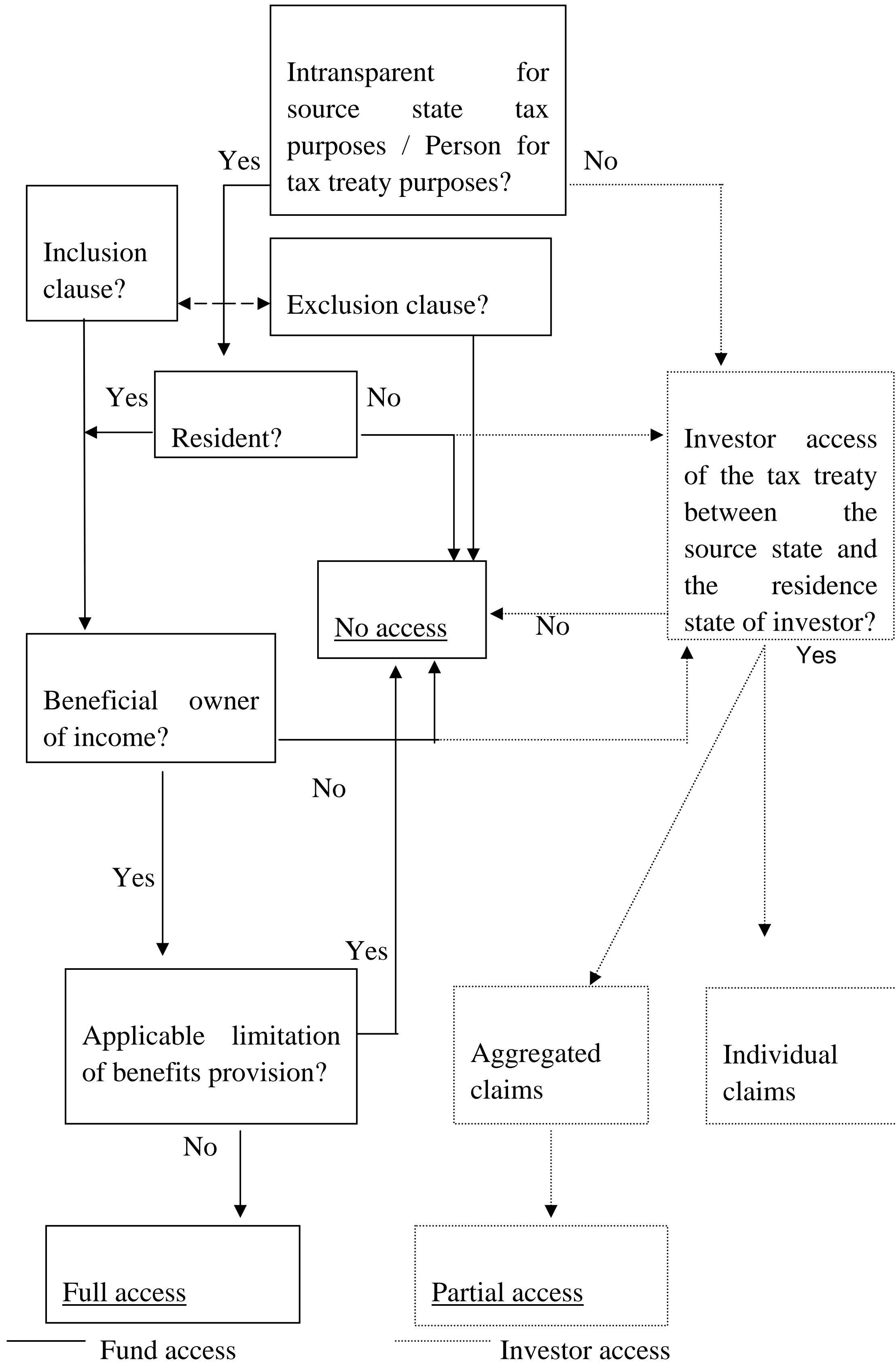

Figure 4. Tax Treaty Access of Investment Funds or Their Investors.

Full access. The investment fund is eligible for tax treaty benefits in its own right, provided that all the conditions for treaty eligibility are satisfied. This approach essentially follows the principle of the substitution of securities, by allowing the investment fund to claim the benefits under the tax treaty between its residence state and the source state of income, irrespective of the residences of underlying investors.[548] From an administrative point of view, this approach is pragmatic, since any investigation of underlying investors and their residences is not necessary.

Partial access. This approach refers to a situation where the treaty benefits, under the treaty between the residence state of the investment fund and the source state of income, are available proportionally to the extent that underlying investors are resident in the same state as the investment fund. In effect, this approach is a combination of fund level and investor level access, because the benefits are allowed by reference to the underlying investors that are resident in the same state as the investment fund, although these benefits are claimed, for practical reasons, by the investment fund on behalf of underlying investors.[549] This approach follows partially the principles of transparency and tax neutrality, though it is also to be noted that the benefits are often practically shared with all investors, irrespective of residence. From an administrative perspective, a sufficient documentation concerning the proportions of resident and non-resident investors in the investment fund must be provided to tax authorities of the source state.

No access. According to this approach, the investment fund is not entitled to tax treaty benefits in its own right, and neither can it claim such benefits on behalf of underlying investors. Depending on the source state in question, individual claims may be accepted under the tax treaties concluded with the residence states of underlying investors. Theoretically, this approach is in accordance with the principles of tax neutrality and transparency, since it allows each investor to claim benefits as if they had received the income directly, rather than through the investment fund. Because of practical difficulties related to individual claims, however, the outcome will be in conflict with the principle of tax neutrality, since the claims cannot be realized by underlying investors.

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[548] Ed – Bongaarts (1997) 52-53.

[549] Cf. Ed – Bongaarts (1997) 56, who are of the view that the investment fund itself is considered as eligible for treaty access to the extent that underlying investors are resident in the same state as the investment fund.

5 TAXATION OF FUND INVESTORS

5.1 Introduction

The final tax subject to be considered in the course of an investment fund investment is the fund investor. In line with the scope of the study, the following examination will cover the tax treatment of fund investors in the United Kingdom, Germany, France and Finland. Moreover, three different cases are considered from the point of view of each jurisdiction. First, the tax treatment of a resident investor investing in a domestic investment fund will be considered. Next, the taxation of a resident investor investing in a foreign investment fund will be examined. Finally, consideration will be given to the tax treatment of a non-resident investor participating in a domestic investment fund.

The examinations of the tax treatment in the three situations will be followed by an evaluation section. In each evaluation section considerations will be offered on the differences in the tax treatment of resident investors, depending on whether these have invested in a domestic or foreign investment fund. Similarly, differences in the tax treatment between resident and non-resident investors investing in a domestic investment fund will be considered. The main purpose of the evaluation sections is to serve the examination of the compatibility of national tax rules with Community law in Chapter 7 of the study.

5.2 United Kingdom

5.2.1 Resident Investor in Domestic Fund

The authorized unit trust (AUT) and open-ended investment company (OEIC)[550] are deemed for UK tax purposes to distribute all their investment income (i.e. dividend, interest) arising in a business year. Hence, a resident unit-holder in a UK investment fund is treated as if all the income received by

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[550] As the tax treatment of the investor is the same, irrespective of whether the investment fund takes the form of the AUT or OEIC, the term ’investment fund’ covers both forms in the following discussion. Similarly the term ’unit’ covers the interest in both the AUT and OEIC.

the fund had been distributed, irrespective of whether there has been an actual cash distribution to the investor, or an accumulation of income within the fund.[551] The tax treatment of income distributions in the hands of an underlying individual investor depends on the income type of a distribution, *viz.* whether it be a dividend or interest distribution. Separate tax rules are applicable to gains realized on the disposal of units of an investment fund by an investor.

For individual unit-holders, income distributions by UK investment funds constituting dividend are treated in exactly the same way as dividends in respect of shares of UK companies. Dividend distributions carry a tax credit of 10 per cent of the grossed-up dividend, or 1/9 of the net dividend.[552] Whether or not the amount of tax credit satisfies the whole tax liability depends on the applicable income tax rate of the unit-holder in question. Dividends are taxed under Schedule F at 10 per cent (ordinary rate) up to GBP 29 900 and in excess of that threshold at 32,5 per cent (upper rate).[553] While persons taxed in accordance with the ordinary rate will have no further tax liability, upper rate taxpayers with 32,5 per cent tax liability are required to pay further tax on dividends.

Interest distributions by investment funds are taxed in the same way as interest paid on other instruments such as bank savings. On paying the distribution to unit-holders, tax at a rate of 20 per cent has to be withheld at source by the payer, to be later offset against the unit-holder's personal tax liability or to be refunded, as the case may be, to the investor. As in the case of dividends, the final tax liability depends on the rate of tax applicable to a unit-holder.[554]

An individual unit-holder is taxed on capital gains made on the redemption[555] of units under normal capital gains tax principles.[556] Generally speaking, capital gains are aggregated with other income and taxed at the income tax rates. However, this is subject to a basic annual exemption of GBP 7 700 and taper relief[557]. If accumulation units are held, each accumulation of

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[551] Smith – Turner, Investment Funds, 97.
[552] Smith – Turner, Investment Funds, 97. From 6 April 1999 the tax credit attaching to dividends reduced from one quarter to one ninth of the net dividend. At the same time, the advance corporation tax (ACT) was abolished. As UK companies pay no longer ACT on dividends, the tax credit is given without regard to the UK tax paid by the company. Under the previous system, the tax credit represented the fact that the company paying the dividend had already paid tax on the profits used to pay the dividend. For changes in the UK corporation and dividend tax system, see Gammie (1998) 429 ff; Hughes (1998) 19 ff.
[553] European Tax Handbook 2003, 685.
[554] Smith – Turner, Investment Funds, 98-100.
[555] This applies, of course, to other disposals such as the sale of units to a third party.
[556] Smith – Turner, Investment Funds, 98-100.
[557] Taper relief reduces the amount of taxable gain according to the length of holding period of the asset by the investor. See for more details, European Tax Handbook 2003, 686.

income is treated as an increase in the cost base of the unit for capital gains tax purposes.[558]

Switches between sub-funds of an umbrella fund are treated as a disposal for capital gains tax purposes. This is a straight consequence of treating a sub-fund, instead of an umbrella fund, as a separate company for UK tax purposes. On the other hand, where an investor switches between different share classes, for example, between income units and accumulation units within the same sub-fund, a switch does not give rise to a disposal for capital gains tax purposes.[559]

Foreign tax credits attached to income received by UK investment funds may be utilized by themselves against their corporation tax liability. Hence, they may not be passed on to underlying investors.[560]

5.2.2 Resident Investor in Foreign Fund

The tax treatment of a UK investor in a foreign investment fund depends, in the first place, on the legal form of the latter. With regard to this, foreign investment funds are divided into three categories on the grounds of legal form[561]: 1) transparent funds, 2) opaque funds and 3) corporate funds.

Funds having no separate legal personality are classified as transparent funds. Foreign investment funds treated as transparent for UK tax purposes are often based merely on contractual arrangements. In a case where a UK investor has interest in an investment fund that is treated as transparent, investment income and capital gains arising within the fund are deemed to constitute income and gains of the UK investor. In practice, UK investors are taxed on investment income received by a transparent fund, at the date of actual distribution by or accumulation of income within the fund, rather than on an arising basis. The tax treatment of investment income in the hands of a UK investor is determined by the nature and source of the underlying income received by the fund, and varies according to whether the income is UK-source or foreign-source dividend, interest or other income. Capital gains

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[558] Smith – Turner, Investment Funds, 101.

[559] Smith – Turner, Investment Funds, 101. This is explained by the fact that the unit prior to a switch and the one after a switch participate in the same underlying assets. See Inland Revenue Tax Bulletin 1998/28 (under “Capital gains tax: authorised unit trust umbrella schemes”). In the case of a switch between sub-funds this is not the case, because each sub-fund is allocated its own assets.

[560] Smith – Turner, Investment Funds, 101.

[561] The principles according to which the Inland Revenue classifies foreign entities are published in Inland Revenue Tax Bulletin, February 1999, 39.

realized by the fund should be taxable annually in the hands of underlying UK investors.[562]

The second category of foreign funds – 'opaque funds' – falls between being completely transparent and having a corporate veil. These typically take the form of a unit trust in a jurisdiction where the trust law is based on UK common law. As for UK investors in opaque funds, investment income is taxed under the same principles as in the case of transparent funds, but for capital gains tax purposes opaque funds are, similarly to UK unit trusts, not transparent. This is because units in a unit trust schemes, whether UK or foreign, are deemed to constitute shares of a company. As a result, for UK unit-holders in opaque funds capital gains realized at the fund level will not be taxable until the units in opaque funds are disposed. Capital gains are taxed under the general capital gains tax principles, with the exception of cases where the UK offshore funds legislation is applicable (see below).[563]

If the income received by a foreign investment fund, whether treated as transparent or opaque, has been subject to foreign tax, UK investors may obtain credit against their UK tax liability for the foreign tax suffered. Similarly, tax credits in respect of UK-source income pass through to the underlying UK investors. If the income of a foreign investment fund treated as transparent in the United Kingdom originates in a state with which the United Kingdom has a tax treaty, UK resident investors should be able to claim treaty benefits individually. However, this depends not only on the UK tax authorities but also on the tax authorities of the source state of income. However, individual claims are practically hampered in most cases by administrative difficulties.[564]

As regards the third and final category – corporate form investment funds – participating UK investors should only be taxable on distributions received from the fund, or on gains realized on the disposal of fund shares. Distributed income is treated as a foreign dividend and is subject to income tax at a rate of 20 per cent. Owing to the absence of transparency, UK investors are not able to benefit individually from UK or foreign tax credits suffered by the fund, but a credit is available for any tax withheld on a distribution in the residence state of the fund, when paid to a UK investor.[565]

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[562] Smith – Turner, Investment Funds, 104-105; KPMG, Funds and Fund Management 2003/United Kingdom, 2.3.
[563] Smith – Turner, Investment Funds, 104-105; KPMG, Funds and Fund Management 2003/United Kingdom, 2.3.
[564] Smith – Turner, Investment Funds, 104-105; KPMG, Funds and Fund Management 2003/United Kingdom, 2.3. See also discussion in Chapter 4.4.5.
[565] Smith - Turner, Investment Funds, 104-105; KPMG, Funds and Fund Management 2003/United Kingdom, 2.3.

Switches by UK investors between sub-funds of a foreign umbrella fund are generally deemed to constitute a disposal for capital gains tax purposes. However, switches between different share classes do not generally give rise to capital gains taxation, providing that the original and new shares or units participate in the same pool of investments.[566]

Irrespective of the entity classification of a foreign investment fund, one has to take into account the rules of the offshore funds legislation applied by the United Kingdom. The legislation was introduced in 1984 to counter the conversion of investment income by UK resident investors into more favorably taxed capital gains, by way of an investment in foreign investment funds which accumulated their income.[567] Recently, minor changes into the legislation were introduced in the 2004 Budget. At the outset, it may be noted that the conversion of investment income into capital gains is of less significance nowadays than it was at the time of introduction of the legislation, since tax rates applicable to investment income and capital gains have converged in the United Kingdom. Nevertheless, the basic annual tax exemption and the availability of taper relief continue to reduce the relative tax burden on capital gains as compared to investment income.[568]

Broadly, the offshore funds legislation applies to foreign investment funds where UK investors are deemed to have the ability to accumulate income tax free.[569] For the purposes of the offshore funds legislation, foreign investment funds are divided into two categories. On the one hand, there are so-called 'distributing funds', which distribute annually at least 85 per cent of their UK equivalent profits (UKEP), thereby excluding capital gains, determined in accordance with the UK corporate tax rules. On the other hand, there are 'non-qualifying funds', which do not meet the distribution requirement referred to above: the UK investors of such funds confront certain disadvantageous tax consequences.[570]

To become a 'distributing fund' within the meaning of the offshore funds legislation, a foreign fund must obtain a certification by making a formal application to the Inland Revenue for each fiscal year within 6 months of the end of an accounting period. A foreign investment fund will be certified after demonstrating that it has distributed at least 85 per cent of its UKEP in an accounting period.[571] The distribution must generally be made within 6 months

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[566] Smith – Turner, Investment Funds, 106.
[567] Hurley (1997) 837.
[568] Smith – Turner, Investment Funds, 106.
[569] The offshore funds legislation uses the term 'material interest' in a non-qualifying fund. For the meaning of material interest, see Collison – Tiley (2003) 34:41.
[570] See Collison – Tiley (2003) 34:42.
[571] In addition, a distributing fund must adhere to certain investment restrictions, as specified by the offshore funds rules. However, the measures adopted in the 2004 Budget will abolish any investment

of the end of the relevant accounting period, and it must be in a form which constitutes taxable income in the hands of UK investors. To avoid the cost incurred by a foreign fund in making disproportionately small distributions, no distribution is required if the gross income of the fund is less than 1 per cent of the average net assets of the fund. Should a foreign investment fund itself have failed to apply for certification, despite satisfying the requirements for certification, there is the possibility for an application by a UK investor for an indirect certification with the Inland Revenue, thus avoiding disadvantageous tax consequences which would otherwise result from the application of the offshore funds legislation.

If a foreign investment fund is not certified as a 'distributing fund', the total return made on the redemption of units is taxed, in the hands of a UK investor, as ordinary income as opposed to capital gains ('offshore income gain'). This prevents the UK investor from taking advantage of the basic annual exemption and taper relief normally applied to capital gains. Therefore, the offshore funds legislation does not as such prevent the accumulation of income in foreign investment funds, but imposes adverse tax consequences taking effect on the redemption of units.[572]

5.2.3 Non-Resident Investor in Domestic Fund

The United Kingdom does not levy a withholding tax on dividend distributions by UK companies.[573] The same applies to dividends paid out by UK investment funds. The tax credit of 1/9 of the net dividend normally carried by a dividend distribution is generally not recoverable for a non-resident investor, since, under UK tax law, a tax credit is not recoverable for non-taxpayers, whether residents or non-residents. Some tax treaties, however, provide for the possibility for a repayment of tax credit in part, in which case the dividend, together with tax credit, are subject to withholding tax as provided by the applicable tax treaty. Nevertheless, the reduction of tax credit to 10 per cent has, in most cases, practically eliminated any repayments of tax credit to non-resident investors.[574]

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restrictions in view of the distributor status. Another change made in the 2004 Budget addresses the issue of umbrella funds. Previously, a certification could only be granted for the entire fund. This meant that each sub-fund of an umbrella fund had individually to meet the distribution requirement in order to qualify as a distributing fund. However, under the new measures each sub-fund and share class of an investment fund can individually qualify as a distributing fund, so that non-qualifying sub-funds and share classes within the same fund do not taint qualifying ones. See Inland Revenue Budget Note (BN) 26, 17 March 2004. See also Inland Revenue (2002a) and (2002b).

[572] For more details of the offshore funds legislation, see Smith – Turner, Investment Funds, 106-108.

[573] European Tax Handbook 2003, 678.

[574] Smith – Turner, Investment Funds, 109. See also Hughes (1998) 21 ff; Gammie (1997) 339.

Interest distributions from UK investment funds to non-resident investors may generally be made without deduction at source, provided that the non-resident investor submits a certificate of being resident outside the United Kingdom. In the case of possible deduction, the withholding tax in excess of the tax treaty rate can later be reclaimed.

Non-resident portfolio investors are not subject to tax on capital gains in the United Kingdom.[575]

5.2.4 Evaluation

Of the jurisdictions covered by this study, only the United Kingdom applies a tax regime under which domestic investment funds may actually have to pay tax on their income. Therefore, when considering the tax treatment of underlying investors in UK investment funds, attention must also be paid to taxation at the fund level.

UK-source vs. foreign-source dividend through a UK investment fund. The first situation to be considered is whether there is a difference in the tax treatment of income in the hands of a resident investor participating in the OEIC[576], dependent on whether the latter makes an investment in shares of a UK company or a foreign company. On the surface, it seems that the preferential tax treatment of UK-source dividends at the fund level, in contrast to foreign-source dividend, could bring with it a potential conflict with the principle of neutrality. In particular, UK-source dividends pass through a UK fund without tax liability at the fund level. In contrast, foreign-source dividend is not tax-exempt at the fund level, but is subject to a 20 per cent tax on the net amount of dividend. On the other hand, when redistributed by a UK investment fund, no distinction between UK- and foreign-source dividends is made, so that even that part of distribution comprising foreign-source dividend carries a tax credit of 10 per cent. In the following example, the tax treatment of a resident investor deriving a UK dividend and a foreign-source dividend (here a German-source dividend) respectively, through the OEIC will be compared.

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[575] Smith – Turner, Investment Funds, 109.

[576] In the following examples, the OEIC is used as an example. However, due to the same tax regime applicable to both the OEIC and AUT, the same result would be arrived at by using the AUT as an example.

Table 2. Resident Investor: OEIC with UK Dividend vs. OEIC with German Dividend.

		OEIC with UK dividend	OEIC with German dividend
	Investment level		
A	Dividend payment	100	100
B	Withholding tax (treaty rate)	n.a.	15
	Fund level		
C	Taxable income	n.a.	100
D	UK corporate tax liability	n.a.	20
E	Tax credit	n.a.	(15)
F	Distributed income[577]	100	80
	Investor level		
G	Income received	100	80
H	Tax credit	10	8,9
I	Taxable income (G+H)	110	88,9
J	Tax liability (at 32,5 %)	35,75	28,9
K	Tax credit	(10)	(8,9)
L	Tax due (J-K)	25,75	20
M	Net income (G-L)	**74,25**	**60**
N	Total tax rate (A-M)	25,75	40

As the example above shows, the total tax liability experienced by a resident investor, *viz.* personal income tax, UK corporate tax, and foreign withholding tax, is higher in the case of foreign-source dividend than UK-source dividend. As the withholding tax levied in the source state may be credited against the UK corporate tax liability, the source of non-neutrality, as a rule, results from the fund's UK tax liability on the income.[578] On the other hand, a UK investment fund may offset management costs against its tax liability on the foreign-source dividend (a possibility not considered in the

[577] Possible deductible expenses as well as the subscription tax of 0,05 per cent in Luxembourg are not taken into account in the following examples for reasons of simplification.

[578] Owing to the fact that UK investment funds are, as a rule, entitled to a reduced withholding tax of up to 15 per cent in the source state of income, such taxes may effectively be credited against UK corporate tax liability. If a withholding tax were to exceed 20 per cent, it could not be credited totally against taxes at the level of the investment fund. This would also increase the total tax liability incurred by the investor.

example above), which may in effect level the differences in the total tax burden of UK- and foreign-source income, depending on the amount of deductible costs.

Domestic investment fund vs. foreign investment fund. The second case to be considered is whether there is a difference in the tax treatment of income in the hands of a resident investor, depending on whether the investment is made through the OEIC or through a foreign investment fund. On the surface, it seems that the absence of tax credit, in respect of income distributions received from foreign investment funds, would result in a higher tax burden than in the case of an investment through the OEIC. In the following, the tax treatment of a UK resident investor in the OEIC and Luxembourg SICAV will be compared both in respect of UK-source and foreign-source dividend.

Table 3. Resident Investor: OEIC with UK Dividend vs. LUX SICAV with UK Dividend.

		OEIC with UK dividend	LUX SICAV with UK dividend
	Investment level		
A	Dividend payment	100	100
B	Withholding tax (treaty rate)	n.a.	n.a.
	Fund level		
C	Taxable income	n.a.	n.a.
D	Corporate tax liability	n.a.	n.a.
E	Tax credit	n.a.	n.a.
F	Distributed income	100	100
	Investor level		
G	Income received	100	100
H	Tax credit	10	n.a.
I	Taxable income (G+H)	110	100
J	Tax liability (at 32,5 %)	35,75	32,5
K	Tax credit	(10)	n.a.
L	Tax due (J-K)	25,75	32,5
M	Net income (G-L)	**74,25**	**67,50**
N	Total tax rate (A-M)	25,75	32,5

Table 4. Resident Investor: OEIC with German Dividend vs. LUX SICAV with German Dividend

		OEIC with German dividend	LUX SICAV with German dividend
	Investment level		
A	Dividend payment	100	100
B	Withholding tax (treaty rate)	15	15
	Fund level		
C	Taxable income	100	n.a.
D	Corporate tax liability	20	n.a.
E	Tax credit	(15)	n.a.
F	Distributed income	80	85
	Investor level		
G	Income received	80	85
H	Tax credit	8,9	n.a.
I	Taxable income (G+H)	88,9	85
J	Tax liability (at 32,5 %)	28,9	27,6
K	Tax credit	(8,9)	n.a.
L	Tax due (J-K)	20	27,6
M	Net income (G-L)	**60**	**57,40**
N	Total tax rate (A-M)	40	42,6

The table shows that the taxation of income received through the OEIC is generally more advantageous than when received through the Luxembourg SICAV. With respect to a UK-source dividend, the difference in the total tax burden incurred by a UK investor accounts for the absence of tax credit in respect of income derived from a non-resident investment fund. With respect to a foreign-source dividend, the different outcome can also be ascribed to the absence of tax credit in respect of income from the foreign investment fund. It must, however, be noted that in the latter case the difference is of minor significance. On the other hand, the deductibility of management costs at the UK fund level, in contrast to the SICAV which may not deduct such costs, could increase the difference between the alternatives.

As a rule, capital gains on the redemption of units of investment funds, whether UK-resident or foreign, are taxed according to the same rules in the hands of UK investors. However, in a case where a UK investor redeems units in a foreign investment fund which is not certified as a ’distributing fund’, disadvantageous tax consequences, caused by the UK offshore funds

legislation, must be taken into account. In such a case, capital gains realized by a UK investor will be taxed as ordinary income rather than as capital gains. The disadvantageous effect, resulting from treating the realized income as ordinary income instead of capital gains, may vary on a case-by-case basis, and depends at least on the applicable tax rate (i.e. ordinary or upper rate), the length of holding period (i.e. the amount of forgone taper relief) and the amount of other capital gains (i.e. the amount of forgone basic annual exemption) of the investor in question. It must also be noted that the investor in a foreign, non-distributing investment fund benefits from the deferral of UK income tax, since income received by the fund is not taxed yearly in the hands of the investor, as is the case for resident investors in UK investment funds. As a consequence, it is difficult to ascertain to what extent, if at all, the application of the offshore funds legislation results in a more disadvantageous tax treatment of resident investors in foreign, as compared to UK, investment funds.

Apart from this, the procedure of applying for certification with the Inland Revenue may indirectly place an additional burden on UK investors in foreign investment funds. This would be the case if a foreign investment fund which in principle would qualify as a distributing fund within the meaning of the offshore funds legislation were to fail to apply for its own certification.[579] In such a case, it is the responsibility of underlying UK investors to apply for an indirect certification, in order to avoid the application of the legislation.[580] In practice, it would be difficult for an individual investor to acquire the information required for certification purposes.[581]

Resident investor vs. non-resident investor. As for the tax treatment of resident and non-resident investors in UK investment funds, it may be noticed that the tax credit related to a dividend distribution by the UK investment fund cannot, as a rule, be claimed by non-resident investors. On the other hand, non-resident investors are subject to withholding tax in the United Kingdom neither on distributions paid out by the UK investment fund (apart from certain types of interest income, and subject to tax treaties) nor on capital gains on redemption of units in the fund. Therefore, for UK tax purposes, non-resident investors are subject to tax on income received from an investment in the UK investment fund only to the extent that the income is taxed on the level of the fund.

[579] For example, because there are only a few UK investors in a foreign investment fund.
[580] Smith – Turner, Investment Funds, 108.
[581] See FEFSI & PricewaterhouseCoopers (2001a) 27.

5.3 Germany

5.3.1 Resident Investor in Domestic Fund

German resident unit-holders are subject to taxation on the basis of general tax provisions in InvStG § 1-10, dealing with investments both in German and foreign investment funds, and specific tax provisions in InvStG § 11-15, dealing only with investments in German funds.[582] Traditionally, the underlying principle of tax provisions applied in Germany has been transparency (*Transparenzgrundsatz*), in the sense that fund investors should be taxed as if they had directly invested in the same underlying securities. In other words, the use of an investment fund as an intermediary should not produce either a lower or higher tax liability for the investor as compared to a direct investment.[583] InvStG continues to follow the principle of transparency, despite that this leads to a very complicated tax regime.[584]

As regards the taxation of investors in German investment funds, the novelty is that the preferential tax treatment is made dependent on the disclosure of certain relevant tax information by investment funds.[585] A fund's failure to comply with the requirements as specified by InvStG will result in a disadvantageous taxation of its German investors. Under the previous regime this was the case only with respect to foreign investment funds, whereas in the case of non-complying German investment funds the investor was taxed by way of an individual assessment.[586] Below, the preferential tax regime and the tax reporting duties connected thereto are first discussed, after which the tax rules applicable in the case of non-complying funds are dealt with.

German investors are taxed either on actual distributions (*Ausschüttung*), in the case of distributing funds, or deemed distributions (*ausschüttungsgleiche Erträge)* in the case of accumulating funds, or on both in the case of partly-accumulating funds. Actual distributions are classified as income from capital (*Einkünfte aus Kapitalvermögen*) within the meaning of EStG § 20(1)(1) (*Einkommensteuergesetz*) as far as they do not belong to the business assets of the recipient.[587] The income which is neither distributed, nor used towards the

[582] InvStG §§ 1-15, which correspond to KAGG §§ 37n-50.
[583] Scheurle (1995) 646. For practical reasons the transparency principle is implemented somewhat imperfectly: see Wiesenbart, Investment Funds, 60-61; Täske (1997) 457-458. If full transparency existed, the fund itself could be disregarded for tax purposes, and only the taxation of investors would be of interest. See Dehnen et al. (2000) 480.
[584] See *Investmentmodernierungsgesetz/Entwurf,* p. 294-295; Mick – Engers (2004) 202.
[585] Mick – Engers (2004) 202.
[586] See *Investmentmodernierungsgesetz/Entwurf,* p. 299.
[587] InvStG § 2(1), which corresponds to KAGG § 39(1). The original components of the income received by the fund are insignificant when determining the income type in the hands of an investor, with the exception of capital gains. See Scholtz (1997) 114.

costs incurred by the fund, is deemed to be distributed at the end of the business year in which the income was received by the fund.[588] Deemed distributions are, similarly to actual distributions classified as income from capital within the meaning of EStG § 20(1)(1).

In the hands of individual investors, the distributions from German investment funds are tax-exempt to the extent that they include capital gains from the disposal of securities, or subscription rights on shares and income from derivative instruments.[589] Capital gains are tax-exempt even if they would constitute so-called short-term capital gains (*Gewinn aus privaten Veräußerungsgeschäften*), which, in the case of a direct share investment, would be taxable.[590] This results in a disruption of the transparency principle, as the treatment of short-term capital gains represents an advantage for investment funds over a direct investor by allowing short-term profit taking.[591] In line with the so-called half-income system applied to the taxation of dividends in Germany, the part of a distribution or deemed distribution comprising dividend from a resident or non-resident company is subdivided into the taxable and the tax-free portions.[592] The taxable part of a distribution is – as with other income from capital – added to an individual's annual aggregate income, and taxed at the marginal tax rate. However, with respect to dividend and interest income, there is an annual allowance of €1 550.[593]

Based on the principle of transparency, a credit in respect of foreign withholding taxes levied on the income received by the investment fund is granted to underlying resident investors.[594] The relief is given in respect of taxes which are creditable under EStG § 34c or under an applicable tax treaty, the rule being that foreign taxes which are comparable to income taxes levied in Germany are creditable.[595] Unlike in the case of a direct investment, the available tax credit is not limited by the applicable German tax payable on the net foreign-source income per country.[596] Instead of a credit method, deduction of foreign taxes may be chosen, if it should turn out to be more

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[588] The taxation of accumulated income was introduced in 1960. Previously, it was possible to defer taxation by accumulating income in the fund and realising the profits as non-taxable capital gains. See Scholtz (1997) 114.

[589] InvStG § 2(3)(1), which corresponds to KAGG § 40(1).

[590] See Wiesenbart, Investment Funds, 42. Capital gains are classified as short-term gains when securities are disposed within 12 months of the acquisition. For taxation of capital gains in Germany, see European Tax Handbook (2003) 243.

[591] Dehnen et al. (2000) 483.

[592] InvStG § 2(2), which corresponds to KAGG § 40(2). See also Tibo (2000) 2291.

[593] €3 100 for jointly-taxed spouses. European Tax Handbook (2003) 243.

[594] InvStG § 4(2). In a case where foreign-source income received by the fund is exempted from tax in Germany under tax treaty provisions, such income is also not taxable in the hands of underlying investors (InvStG § 4(1)).

[595] See Stotz (1998) 259.

[596] Wiesenbart, Investment Funds, 66.

favorable for a taxpayer.[597] Should the foreign withholding taxes be already deducted as an expense when calculating income at the fund level, underlying investors are not entitled to a credit or deduction.[598]

The above-described tax rules are applied to income derived from a German investment fund only to the extent that the investment fund complies with the tax reporting duties as specified in InvStG § 5. To a considerable extent, the duties correspond to those laid down in the KAGG[599] and AuslInvestmG[600]. The reason behind the comprehensive information requirements is the fact that, to be able to declare the taxable income for German tax purposes, investors need very detailed information on the items of income received by the investment fund.[601]

In accordance with InvStG § 5(1)(1), in the case of a distribution, the investment fund must notify its investors of the amount of a distribution, and must provide a detailed breakdown of items contained in the distribution, as specified by the law. The breakdown as required by the law is extremely detailed, in that it comprises some 20 items of information which are needed either by individual investors or by corporate investors, or by both, in order to effect the taxation under the German tax law. The information includes, for example, the amount of tax-exempt capital gains, of dividends entitled to the half-income method, and any creditable foreign taxes. In accordance with InvStG § 5(1)(2), in the case of accumulation of income, the investors must be notified of the same information within four months of the end of the fund's business year. In both the cases, the information must additionally be published in electronic form in the *Bundesanzeiger* (German Official Gazette) together with the annual report of the fund.[602]

In the case of non-compliance with the information requirements, investors of the fund will be taxed under InvStG § 6 which prescribes taxation based on a fictitious amount, consisting of actual distributions, if any, and of an amount corresponding to 70 per cent of the increase in the price of a unit over a calendar year.[603] In any case, the minimum taxable amount is set to six per cent of the last published redemption price in a calendar year.

For capital gains tax purposes, a distinction must be made between the capital gains realized at the fund level and at the investor level. The tax exemption of short-term capital gains applicable to investment funds does not

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[597] See Lohr – Graetz (1995) 117; Stotz (1998) 260.
[598] InvStG § 4(4).
[599] KAGG §§ 41 and 47, concerning German investment funds.
[600] AuslInvestmG § 17, concerning foreign investment funds.
[601] See *Investmentmodernierungsgesetz/Entwurf,* p. 298.
[602] InvStG § 5(1)(3).
[603] Specifically, 70 per cent of the difference between the first and last published redemption price of the unit in a calendar year.

extend to the investor level. As a result, capital gains on the redemption of units are taxable as short-term capital gains, if they are realized within 12 months of the acquisition, and to the extent that the total gains are at least €512 during the tax year.[604] The half-income method is applicable to capital gains on investment fund units, to the extent that the gain comprises qualifying income – referred to as '*Aktiengewinn'* (profit from shares) – in particular, dividend and capital gains (whether realized or unrealized) from shares of companies.[605] The extension of the concept *Aktiengewinn* to individual investors is a novelty as compared to the KAGG where it was only applicable to corporate investors.[606] However, the new treatment follows the transparency principle since, in the case of a direct investment, the half-income method would also be applicable to dividend and capital gains on shares. The application of *Aktiengewinn* treatment is dependent on the fund determining and publishing the amount of *Aktiengewinn.*[607] Capital gains on units held for at least 12 months are not taxable, in line with the general capital gains tax principles.

As of 2004, the so-called interim profits taxation (*Zwischengewinn-besteuerung*) is abolished; this was a special type of taxation applied to interest and income alike[608] accrued to the fund but not yet distributed, or deemed to be distributed, at the moment of disposal of units.[609] The objective of the interim profits taxation was to prevent the investor from converting taxable interest income into non-taxable capital gains by disposing of the units before the day of distribution.[610] However, complications involved with interim profits taxation were considered to outweigh any benefits brought about by its application.[611]

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[604] EStG § 23(1)(2)(nr. 2).

[605] InvStG § 8(1). For details see, *Investmentmodernierungsgesetz/Entwurf,* p. 313.

[606] KAGG § 40a(1).

[607] InvStG § 5(2).

[608] Broadly speaking, interim profits included interest income on certain type of securities such as bonds, zero-bonds and money market instruments as well as income from derivative transactions accrued to the fund. See Bölter et al. (1998) 169-176.

[609] See KAGG § 39(2). Interim profits constituted income from capital within the meaning of EStG § 20(1)(1) similarly to distributions.

[610] See Wiesenbart, Investment Funds, 64; Dehnen et al. (2000) 484. In other words, it contributed to the neutral tax treatment of direct and fund investors. See Scheurle (1998) 1104.

[611] See *Investmentmodernierungsgesetz/Entwurf,* p. 297-298. For example, fund management companies were required to calculate and publish daily the amount of interim profits in the fund (KAGG § 41(4)). Moreover, the tax treatment of interim profits could turn out to be extremely complicated at the investor level. For example, when the investor acquired units between two distributing periods, the result was 'negative interim profits'. Interim profits were taxable according to net principle, so that negative interim profits were deducted from positive interim profits. If negative interim profits exceeded the amount of positive interim profits, they were deductible against other taxable income. This could be the case when the investor bought more fund units than were sold over the tax year. A withholding tax at a rate of 30 per cent was also levied on the amount of interim profits.

Switching between sub-funds of an umbrella fund is generally assumed to be a taxable disposal for capital gains tax purposes. While this was earlier of no significance in the case of German investment funds[612], the introduction of the umbrella fund structure increases the significance of the issue.

5.3.2 Resident Investor in Foreign Fund

As of 2004, the tax treatment of income from foreign fund investments has fundamentally changed. The earlier distinction between three categories of foreign investment funds (the white, grey and black groups)[613] for the purposes of taxing German investors is abolished. Under the new approach, income derived from domestic and foreign investments is, as a rule, taxed in the same way. This is a remarkable change to the previous tax regimes (KAGG and AuslInvestmG) where several differences in substantive tax rules existed between German and foreign investment funds.[614] However, the preferential taxation of investors continues to be dependent on the compliance with certain obligations concerning the disclosure of tax-relevant information which is required to effect the taxation of German investors. The requirement to appoint a German tax representative[615] in certain cases is also abolished. In the following, the taxation of German investors in foreign investment funds is dealt with. The focus of the discussion is on the remaining differences between German and foreign investment funds and on the changes as compared to the previous tax regimes.

German investors of foreign investment funds are taxed either on actual distributions (*Ausschüttung*) in the case of distributing funds, or on deemed distributions (*ausschüttungsgleiche Erträge)* in the case of accumulating funds, or on both in the case of partly-accumulating funds. Actual distributions are classified as income from capital (*Einkünfte aus Kapitalvermögen*) within the

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[612] Wiesenbart, Investment Funds, 66.

[613] To the white group belonged the foreign funds that had fulfilled the conditions laid down in the AuslInvestmG for the registration for public distribution in Germany, or that were listed on the official or regulated market of a German stock exchange, and which complied with the duties concerning information disclosure for German tax purposes. Specifically, these duties included: i) publication of relevant tax information upon each distribution or deemed distribution, ii) calculation and publication of interim profits and so-called accumulated deemed distribution on a daily basis, and iii) provision of information relevant for tax purposes to the Federal Tax Office (AuslInvestmG § 17(3)(1-3)). See also Wiesenbart, Investment Funds, 71. To the grey group belonged the non-registered foreign funds that had appointed a so-called tax representative and had complied with the requirements to provide evidence on the taxable income and submit the information with German tax authorities (AuslInvestmG § 18(2)). To the black group belonged all other foreign funds which did not qualify as white or grey group funds.

[614] See also *Investmentmodernierungsgesetz/Entwurf,* p. 295.

[615] The tax representative was a person who represented the foreign fund in matters relating to taxation in Germany.

meaning of EStG § 20(1)(1) (*Einkommensteuergesetz*) insofar as they do not belong to the business assets of the recipient.[616] The income which is neither distributed nor used towards the costs incurred by the fund is deemed to be distributed at the end of the business year in which the income was received by the fund. Deemed distributions are, similarly to actual distributions, classified as income from capital within the meaning of EStG § 20(1)(1). The annual allowance of €1 550 (or €3 100 for jointly-taxed spouses) is also applicable. In this respect, the tax rules correspond to the previous tax regime.

However, unlike under the AuslInvestmG, the distributions from all foreign investment funds are tax-exempt in the hands of individual investors, to the extent that they include capital gains from the disposal of securities or of subscription rights on shares, and income from derivative instruments.[617] Previously, the preferential treatment of capital gains was confined to white group funds[618], in order to discourage German investors from investing in other foreign investment funds which evaded supervision by German authorities.[619] Unlike under the AuslInvestmG, the application of the half-income system applies also to dividends, whether from resident or non-resident companies, received through foreign investment funds.[620]

Unlike the previous tax regime, the InvStG also provides for the same tax treatment, in respect of foreign withholding taxes levied on the income received by the investment fund, irrespective of whether the latter may be German or foreign. As a rule, a credit is granted to underlying investors.[621] However, should the foreign withholding taxes be already deducted as an expense when calculating income at the fund level, underlying investors are not entitled to a credit or deduction.[622] Under the AuslInvestmG, foreign taxes which were levied on the income received by a foreign investment fund were not generally creditable in Germany. Rather, the treatment of such taxes depended on how they were taken into account at the fund level in the state of residence.[623]

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[616] InvStG § 2(1).

[617] InvStG § 2(3)(1), which corresponds to KAGG § 40(1).

[618] AuslInvestmG § 17(2)(1)

[619] Hence, the tax rules served indirectly as a means of investor protection. See Bölter et al. (1998) 36; Stotz (1998) 244; Graetz (1999) 117.

[620] InvStG § 2(2). The application of the half-income system to distributions from white group funds was expressly excluded under AuslInvestmG § 17(1) and from grey group funds under AuslInvestmG § 18(1). See also Tibo (2000) 2293.

[621] InvStG § 4(2). In a case where foreign-source income received by the fund is exempted from tax in Germany under tax treaty provisions, such income is also not taxable in the hands of underlying investors (InvStG § 4(1)).

[622] InvStG §4(4).

[623] See Lohr – Graetz (1995) 119. As a concession for white group funds, a tax levied at source on the income received by the fund was credited against the German tax at the level of an investor, insofar as the first-mentioned tax had led to a reduction of the tax withheld on the distribution paid out by the fund to the German investor (AuslInvestmG § 19(3)). France, for example, allows domestic

The preferential tax rules are applied to income derived from a foreign investment fund only to the extent that the investment fund complies with the tax reporting obligations as specified in InvStG § 5. To a large extent, the duties correspond to those laid down in AuslInvestmG[624]. As with German investment funds, the foreign investment fund must notify its investors of the amount of a distribution and of a deemed distribution within the given time limit, and must provide a detailed breakdown of items contained in the distribution as specified by the law, as well as publish the information in electronic form in the *Bundesanzeiger* (German Official Gazette) together with the annual report of the fund.[625] The information must be provided and published in the German language. In addition to obligations applicable to both German and foreign investment funds, the latter must comply with two additional obligations. In the first place, the amount of accumulated income since 31 December 1993 which is deemed to be distributed ('accumulated deemed distribution') must be determined and published in connection with the redemption price.[626] Secondly, the foreign investment fund must provide proof of the correctness of the information, and this must be notified and published within three months of any request by the *Bundesamt für Finanzen.*[627] The two requirements correspond to those laid down in AuslInvestmG for white group funds.

In the case of non-compliance with the information obligations, investors of the fund will be taxed under InvStG § 6 which prescribes taxation based on a fictitious amount, consisting of actual distributions, if any, and of an amount corresponding to 70 per cent of the increase in the price of a unit over a calendar year.[628] In any case, the minimum taxable amount is set to six per cent of the last published redemption price in a calendar year. The taxation under InvStG § 6 corresponds to that applied to black group funds under AuslInvestmG § 18(3), though in a milder form. Under AuslInvestmG § 18(3), the corresponding percentages were set to 90 per cent and 10 per cent. As a result, the taxation of German investors in black group funds was widely considered to be quasi-penal.[629]

Capital gains on the redemption of units are taxable as short-term capital gains if they are realized within 12 months of the acquisition, and to the extent

investment funds to have a tax paid in the source state of income credited against the French withholding tax levied on fund distributions. This arrangement is dependent on tax treaty provisions. For an example, see Baranowski (1996) 670.

[624] AuslInvestmG § 17.

[625] InvStG § 5(1)(3).

[626] InvStG § 5(1)(4).

[627] InvStG § 5(1)(5).

[628] Specifically, 70 per cent of the difference between the first and last published redemption price of the unit in a calendar year.

[629] See Wiesenbart, Investment Funds, 74.

that the total gains are at least €512 during the tax year.[630] As in the case of German investment funds, the half-income method is applicable to capital gains on investment fund units to the extent that the gain comprises *Aktiengewinn*.[631] The extension of the concept *Aktiengewinn* to income derived from foreign investment funds is altogether a novelty, since the AuslInvestmG, in contrast to the KAGG, did not deal with it. The application of the *Aktiengewinn* treatment is dependent on the fund determining and publishing the amount of *Aktiengewinn*.[632] Capital gains on units held for at least 12 months are not taxable, in line with general capital gains tax principles.

As in the case of German investment funds, the so-called interim profits taxation (*Zwischengewinnbesteuerung*), and the reporting requirements related thereto, are abolished.[633]

A switch between sub-funds of an umbrella fund is likely to constitute a disposal for capital gains tax purposes.[634]

Both actual and deemed distributions, to the extent that they constitute taxable income, are subject to a 30 per cent withholding tax (ZASt) if paid to a German investor through a paying agent established in Germany.[635] However, unlike in the case of German investment funds, the dividend portion of a distribution is not subject to withholding tax, since foreign investment funds cannot be obliged to withhold such tax under German law, and German paying agents are not obliged to withhold a tax on dividends.[636] On the other hand, in the case of foreign accumulating funds, a German paying agent must levy a withholding tax on all accumulated deemed distributions from the time of acquisition of units by an investor.[637] Insofar as no German paying agent is involved, the rules concerning withholding taxes are not applicable.[638]

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[630] EStG § 23(1)(2)(nr. 2).
[631] InvStG § 8(1). For details see, *Investmentmodernierungsgesetz/Entwurf,* p. 313.
[632] InvStG § 5(2).
[633] AuslInvestmG § 17(3)(3) required white group funds to publish the amount of interim profits on a daily basis and AuslInvestmG § 18(2) grey group funds to provide such information in conjunction with other information concerning taxable income. See also Lohr – Graetz (1995) 105. For black group funds, the taxation of interim profits was replaced by taxing a fictitious amount corresponding to 20 per cent of the redemption price when the units were redeemed (AuslInvestmG § 18(3)). This resulted from the fact that black group funds did not fulfill tax reporting requirements and thus the information needed for the determination of interim profits was not available.
[634] Wiesenbart, Investment Funds, 74.
[635] InvStG § 7(1)(1-2).
[636] See *Investmentmodernierungsgesetz/Entwurf,* p. 299.
[637] InvStG § 7(1)(3), which corresponds to AuslInvestmG § 18a(1a). See also Stotz (1998) 256.
[638] See Brinkhaus – Scherer (2003) 1534; Stotz (1998) 254-259; Bölter et al. (1998) 77-78.

5.3.3 Non-Resident Investor in Domestic Fund

Non-resident investors of German investment funds are, in principle, subject to the same withholding taxes as resident investors, subject to tax treaty provisions. Hence, a withholding tax at the rate of 20 per cent (KapSt) is levied on dividend income, irrespective of whether this is distributed or accumulated in the fund.[639] For tax treaty purposes, Germany generally treats, by way of express treaty provision, a distribution from a German fund as a dividend, though it is not entirely clear whether this also covers other, non-dividend, income items of a distribution.[640] It is notable that the half-income system is not applicable to income received by non-resident investors, so that the total amount of dividends is taxable.[641] In general, interest income paid to a non-resident investor is exempted from a withholding tax in Germany, although in the case of its qualification as dividend for tax treaty purposes when received through an investment fund, the tax would in principle be applied. In the case of an accumulating fund, a withholding tax of 30 per cent will be levied[642], which also applies to that part of interest allocated to non-resident investors. Non-resident investors may afterwards claim refund in respect of any withholding tax imposed in excess of the rate provided for by an applicable tax treaty.[643] Capital gains realized by non-resident investors upon disposal of units in German investment funds are not subject to tax in Germany.[644]

5.3.4 Evaluation

Foreign vs. domestic investment fund. The changes brought about by the introduction of the new InvStG as of 1 January 2004 became necessary, according to the Government Proposal, primarily on account of the doubts of the Community law compatibility of the AuslInvestmG.[645] However, the intention of the reform was also to simplify the tax regime and to make it more transparent.[646] It is also arguable that the taxation of income derived from

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[639] InvStG § 7(3).
[640] See Vogel et al. (1997) 677-678, according to whom only the part of a distribution consisting of dividends qualify as dividend for tax treaty purposes. Wiesenbart, Investment Funds, 76, takes the view that the whole distribution is qualified as dividend for tax treaty purposes irrespective of original items of income.
[641] See, for example, Berger-Quack (2001) 85.
[642] InvStG § 7(4).
[643] See KPMG, Funds and Fund Management 2003/Germany, 2.0 and 5.0.
[644] Wiesenbart, Investment Funds, 76.
[645] *Investmentmodernierungsgesetz/Entwurf,* p. 154.
[646] *Investmentmodernierungsgesetz/Entwurf,* p. 295.

foreign investment funds had become ever more disadvantageous, as compared to that derived from German funds. In particular, in the wake of tax reforms concerning dividend taxation, the German legislators departed from the earlier principle of aiming for a neutral tax treatment between investments in domestic and white group foreign funds. Consequently, only income received through domestic investment funds was made eligible for the application of the half-income system, whereas income through foreign funds was expressly excluded from the system.[647]

On account of the consolidation of substantive tax rules applicable to domestic and foreign investment funds, it is safe to expect that, as a rule, the tax treatment of income for the German investor is the same, whether derived through a German or a foreign investment fund.[648] Under the new regime, the differences in the tax treatment of German investors would follow only insofar as the German and foreign investment fund differ in their compliance with the obligations concerning information disclosure.

In the following examples, the tax treatment of a German resident investor in a German investment fund and Luxembourg SICAV will be compared both in respect of a German dividend and a foreign-source dividend.

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[647] To illustrate the German legislators' overall unwillingness to extend the half-income system in cross-border transactions, it may also be mentioned that, according to the original Government Proposal, the half-income system would have been applicable only in respect of dividends paid by domestic companies, but not by foreign companies when received through a domestic investment fund. It is obvious that this would have also seriously hampered the use of domestic investment funds as a means of cross-border investments in comparison to direct investments. In the final version of the Government Proposal, the application of the half-income system even to foreign-source dividends received through a domestic investment fund was confirmed. See Tibo (2000) 2291.

[648] In the case of a corporate investor, and where the German CFC legislation would apply, this may not hold true. See Jacob (2004).

Table 5. Resident Investor: Sondervermögen with German Dividend vs. LUX SICAV with German Dividend.

		Sonder-vermögen with GER dividend	LUX SICAV with GER dividend
	Investment level		
A	Dividend payment	100	100
B	Withholding tax (treaty rate)	n.a.	15
	Fund level		
C	Taxable income	n.a.	(100)
D	Corporate tax liability	n.a.	n.a.
E	Tax credit	n.a.	(7,5) [649]
F	Distributed income[650]	100	92,5
	Investor level		
G	Income received	100	92,5
H	Tax credit	n.a.	n.a.
I	Tax-free income	50	46,25
J	Taxable income	50	46,25
K	Tax liability (at 40%)	20	18,5
L	Tax credit	n.a.	n.a.
M	Tax due (K-L)	20	18,5
N	Net income (I+(J-M))	**80**	**74**
O	Total tax rate (A-N)	20	26

[649] The fund avails itself of the possibility under InvStG § 4(4) to deduct foreign withholding tax from income calculated at the fund level for the tax purposes of the German investor. In accordance with InvStG § 4(3), only that part of taxes allocated to the taxable part of income are deductible.

[650] Possible deductible expenses as well as the subscription tax of 0,05 per cent in Luxembourg are not taken into account in the following examples for reasons of simplification.

Table 6. Resident Investor: Sondervermögen with Finnish Dividend vs. LUX SICAV with Finnish Dividend.

		Sonder-vermögen with FIN dividend	LUX SICAV with FIN dividend
	Investment level		
A	Dividend payment	100	100
B	Withholding tax (treaty rate)	15[651]	15[652]
	Fund level		
C	Taxable income	(100)	(100)
D	Corporate tax liability	n.a.	n.a.
E	Tax credit[653]	(7,5)	(7,5)
F	Distributed income	92,5	92,5
	Investor level		
G	Income received	92,5	92,5
H	Tax credit	n.a.	n.a.
I	Tax-free income	46,25	46,25
J	Taxable income	46,25	42,25
K	Tax liability (at 40%)	18,5	18,5
L	Tax credit	n.a.	n.a.
M	Tax due (K-L)	18,5	18,5
N	Net income (I+(J-M))	**74**	**74**
O	Total tax rate (A-N)	32	32

With respect to German-source dividend, the investment through the SICAV is in a disadvantageous tax position as compared to the investment through the German fund. This is because the dividend paid to the SICAV is subject to withholding tax in Germany, whereas in the case of a German investment fund no withholding tax is levied, or it is at least refunded to the fund. However, in the case of a foreign-source dividend, the tax treatment is exactly the same. Prior to the InvStG, the income derived from foreign investment funds was treated less favorably, in that neither was the half-

[651] Art. 10(2)(c) of the Finland-Germany tax treaty.
[652] Art. 10(2)(b) of the Finland-Luxembourg tax treaty.
[653] The fund avails itself of the possibility under InvStG § 4(4) to deduct foreign withholding tax from income calculated at the fund level for the tax purposes of the German investor. In accordance with InvStG § 4(3), only that part of taxes allocated to the taxable part of income are deductible.

income system applied, nor was a credit or deduction in respect of withholding taxes levied in the source state available.

Resident vs. non-resident investor. Investors, whether residents or non-residents, of the German investment fund are subject to a withholding tax of 20 per cent with respect to dividends whether accumulated or distributed by the fund. The half-income system is not applied to dividend when paid out by the investment fund, so that the whole amount is subject to a withholding tax in the case of both resident and non-resident investors. However, resident investors benefit from the half-income system in their final taxation.

5.4 France

5.4.1 Resident Investor in Domestic Fund

Under the French tax rules, which have been enacted based on the principle of transparency, resident investors of French investment funds are placed in the same situation as if they had invested directly in the same underlying securities as the investment fund. This applies both to the type of income as well as to the availability of tax reliefs in respect of, or tax credits related to, income. However, the taxable event for the investor is the actual distribution by the investment fund, not the receipt of income by the latter. Since there are no deemed distribution rules, income may also be annually accumulated in French investment funds, without tax consequences at the level of fund or investor.[654] As a rule, investment income is subject to tax at progressive rates in the hands of individual investors.[655]

The income received by French investment funds flows through to underlying investors, retaining its original character. As regards the FCP, this follows from the absence of legal personality. Consequently, income received and distributed by the FCP is subdivided into its original components, and the investor is taxed on each item of income and granted the appropriate relief, as if the investments were made directly and not through the FCP.[656]

The application of the flow-through principle to the SICAV requires specific tax provisions since the income paid out by the SICAV to its investors would otherwise constitute dividend. To facilitate the flow-through of income,

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[654] Blanluet – Portier, Investment Funds, 60. However, accumulation of income may result in the loss of certain tax credits at the investor level. See the discussion below.
[655] Blanluet – Portier, Investment Funds, 57.
[656] Blanluet – Portier, Investment Funds, 57.

the SICAV is authorized to create specific 'coupons' for certain categories of income. The principal coupon categories are[657]:

- French-source dividend with or without imputation credit (*avoir fiscal*);
- Interest from non-indexed negotiable bonds issued in France;
- Interest from certain negotiable instruments such as Treasury bills;
- Certain tax exempt-income;
- Other income, in particular foreign-source dividend.

The most significant items of relief available to resident investors of the FCP and SICAV are[658]:

- A relief up to €1 220[659] in respect of French-source dividends;
- The option to pay a final levy (prélèvement libératoire) at flat rates in respect of French-source interest income[660].

Owing to tax exemption, the SICAV and FCP may not take advantage of tax credits attached to domestic and foreign-source income. Instead, these tax credits may, under certain conditions and subject to certain limitations, be passed on to underlying investors when the income is distributed. If the distribution of income is deferred, rather than distributed within the same year as it was received by the fund, the portion of tax credits attached thereto remains transferable – for the FCP for two tax years following the year of receipt of income, and for the SICAV over the next four tax years. Accumulation of income in excess of the given time limits will result in the loss of credits. The most significant tax credits transferable to investors of French investment funds include[661]:

- Imputation credit (*avoir fiscal*) attached to French-source dividend, equal to 50 per cent of the dividend distribution;
- Tax credit for foreign-source investment income under tax treaties.

French investment funds are required to calculate the total amounts of tax credit. Separate sets of credit will be determined for resident investors and non-resident investors. The amount of tax credits transferable to resident investors includes all the tax credits in respect of French and foreign-source income. The unitary credit per share or unit equals the aggregate amount of tax credits divided by the total number of units or shares on the day of the distribution of income by the French investment fund. A so-called 'maximum credit rule' is applied, under which the credit transferred to the investor may

[657] Blanluet – Portier, Investment Funds, 57-58.
[658] See Blanluet – Portier, Investment Funds, 57 and European Tax Handbook 2003, 219.
[659] €2440 for jointly-taxed spouses.
[660] For example, 15 per cent on interest on government and corporate bonds. See European Tax Handbook 2003, 219.
[661] See Blanluet – Portier, Investment Funds, 64-65 and European Tax Handbook 2003, 219.

not exceed the credit to which the latter would have been entitled had the income been received directly.[662]

Capital gains on securities, including fund units and shares, realized by an individual investor are taxed at the flat rate of 16 per cent, if the aggregate proceeds from the sale of securities in a tax year exceed €15 000.[663]

French tax law is silent on the question as whether a switch between different share or unit classes constitutes a taxable event for capital gains tax purposes. The same applies to switches between sub-funds of an umbrella fund, although it seems that the French tax authorities consider that this at least is deemed to constitute a disposal for capital gains tax purposes.[664]

5.4.2 Resident Investor in Foreign Fund

Unlike domestic investment funds, foreign investment funds with French investors are not treated as transparent entities. This holds true even if the foreign investment fund in its residence state were treated as a transparent entity. The refusal to recognize the transparency of foreign investment funds follows from the need of administrative simplification: from a French point of view, applying the principle of transparency to foreign investment funds is considered to make the enforcement of tax laws too complex, if not impossible.[665]

As a result, the income distributed by a foreign investment fund is taxed in the hands of a French investor as income from foreign shares, *viz.* foreign-source dividend, regardless of the character of underlying income originally received by the fund. The taxable event for a French investor is the actual distribution of the income by the foreign investment fund.[666] From the standpoint of the French tax authorities, and for the purposes of applying tax treaties concluded by France, the distributed income is considered to have its

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[662] See Blanluet – Portier, Investment Funds, 65.
[663] European Tax Handbook 2003, 220.
[664] See Blanluet – Portier, Investment Funds, 63-64.
[665] Blanluet – Portier, Investment Funds, 69-70.
[666] French tax law does not contain any specific provisions with regard to the taxable event for resident investors in foreign investment funds. It is believed that capital gains realized or income received by a foreign investment fund is not subject to tax in the hands of underlying French investors until such income is actually distributed to investors. This conclusion is supported by the general principles which govern the taxation of income earned by individuals. In accordance with these principles, income from securities investments is taxed either in the year of payment or in the year in which the income is credited to an account, and tax is imposed when the income is actually received or if its receipt depends only on the taxpayer. In the end, the taxable event of distribution in the hands of a French investor will depend on his discretion to determine the timing of a distribution. In the absence of such discretion, the undistributed income will not be taxable until actually distributed to a French investor. See Blanluet – Portier, Investment Funds, 70.

origin in the state where the investment fund is established.[667] Withholding taxes levied on the distribution in the residence state of the foreign investment fund are creditable for the French investor, provided that the relevant tax treaty is applicable to the income.[668] However, French investors may not invoke the provisions of a tax treaty between France and any third state from which the foreign fund derives income.[669] Neither may French investors benefit from reliefs available under French tax laws in respect of certain items of income.[670]

Capital gains on securities realized by an individual investor are taxed at the flat rate of 16 per cent, if the aggregate proceeds from the sale of securities in the tax year exceeds €15 000.[671]

There are no provisions dealing with a switch between share classes or sub-funds of an umbrella fund. The position of the French tax authorities seems to be that switching between sub-funds is deemed to be a taxable event for capital gains tax purposes in France, regardless of whether or not switching constitutes a disposal in the residence state of the foreign investment fund.[672]

5.4.3 Non-Resident Investor in Domestic Fund

Non-resident investors are generally subject to a withholding tax on distributions from French investment funds. A distinction must, however, be drawn between the SICAV and FCP.

Where the income is derived from the SICAV, the distribution is generally regarded as a French-source dividend, regardless of the original source or character of underlying items of the income. A distribution is subject to a withholding tax of 25 per cent, or at a lower rate based on a tax treaty provision. If the SICAV derives its income entirely from French bonds, its distribution is classified as interest income from bonds rather than as dividend, and thus is subject to withholding tax provisions relating to interest income. Interest income from French bonds accruing from 1 January 1987 is exempt from withholding tax under the French tax law. A distribution from the SICAV does not entitle its recipient to *avoir fiscal*.[673]

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[667] Blanluet – Portier, Investment Funds, 70.
[668] Blanluet – Portier, Investment Funds, 71.
[669] Blanluet – Portier, Investment Funds, 71. It must also be noted that, for the purposes of individual income tax, French tax law does not contain any unilateral provisions for the prevention of double taxation, in the absence of a tax treaty. European Tax Handbook 2003, 227.
[670] For available reliefs, see discussion in the previous section.
[671] European Tax Handbook 2003, 220.
[672] Blanluet – Portier, Investment Funds, 71.
[673] See Blanluet – Portier, Investment Funds, 73-74; Blanluet (1997) 437-438.

The SICAV is required to calculate the amount of tax credits to be transferred to its non-resident shareholders in the case of a distribution. In particular, the SICAV may transfer tax credits attached to foreign-source income, and *avoir fiscal* attached to French-source dividends, to its non-resident shareholders. Tax credits in respect of foreign-source income comprise the excess withholding taxes which the SICAV is entitled to reclaim, based on tax treaties between France and the source state of income. The credit of *avoir fiscal* is dependent on the provisions of the tax treaty between France and the residence state of the underlying investor. The amount of tax credits granted to the non-resident shareholder is deductible from the withholding tax levied on the gross distribution, including the amount of tax credits from the SICAV. In all cases, the amount to be imputed per share is limited to 1/3 of the net dividend. Tax credits in excess of the set limit are carried forward over the next four fiscal years.

Owing to transparency, a distribution by the FCP is subject to withholding tax, in accordance with the nature of the underlying income, as far as this originates from French sources. Consequently, French-source dividends received through the FCP are subject to a withholding tax of 25 per cent, and interest income is generally exempted from withholding tax. A non-resident unit-holder is, under certain conditions, entitled to any lower withholding tax rate provided for by a tax treaty between the state of residence and France. Treaty benefits are granted in proportion to each category of income giving entitlement thereto, and subject to the condition that the manager or depositary of the FCP – in its capacity as withholding agent – is supplied with the evidence required for the application of the tax treaty. If the FCP distributes income derived from sources outside France, no withholding tax is levied in France on such income.[674]

Since the FCP is treated as a transparent entity, it is theoretically possible to transfer the tax credits and *avoir fiscal* to non-resident unit-holders in the same way as to resident unit-holders. In principle, the FCP is also required to calculate a set of tax credits likely to be transferred to non-residents, which is then added to the amount of distribution to a non-resident for French withholding tax purposes. In practice, the transferable tax credits to non-residents are restricted to repayment of French withholding taxes on certain bonds issued prior to 1987. Tax credits provided by tax treaties, in respect of foreign-source income received, may not be transferred to non-resident investors. This follows from the refusal of the French tax authorities to apply tax treaties concluded between France and the source state of income to third-state residents, *viz.* non-resident unit-holders of the FCP. A non-resident unit-

[674] See Blanluet – Portier, Investment Funds, 74; Blanluet (1997) 438-439.

holder may, however, benefit from *avoir fiscal* provided that this is claimed, on the basis of the tax treaty between the state of residence and France.[675]

Non-residents are, as a rule, not taxable in France on capital gains derived from the disposal of French securities. Therefore, capital gains from the redemption of shares or units in French investment funds are not subject to tax in France.[676]

5.4.4 Evaluation

Foreign vs. domestic investment fund. The main difference in the tax treatment of French investors in domestic investment funds, as compared to foreign investment funds, is that only in the former case does the principle of transparency prevail. The specific rules facilitating transparency in the case of the SICAV are not applicable to investors in foreign investment funds. Even if the foreign investment fund were comparable to the French FCP, transparency would not be recognized for French tax purposes. The absence of transparency in the case of foreign investment funds leads to significant differences in the tax treatment of resident investors, depending on whether the investment is made in a French or in a foreign investment fund.

In the first place, the flow-through of income in the case of domestic funds makes it possible for French investors to take advantage of tax reliefs and tax credits which are specifically related to certain items of income. The most significant difference between domestic and foreign investment fund investments is likely to arise from the different tax treatment of dividend income received through the fund.[677] In the first place, a relief of €1200 in respect of French-source dividends is applicable only for resident investors of French investment funds. In the second place, the *avoir fiscal* is creditable only for resident investors of French investment funds. Finally, withholding taxes paid by the fund in the source state of income can be credited against the resident investor's tax liability only in a case where the income is received through a French investment fund. In the example below, the taxation of French-source dividend in the hands of a French investor will be compared

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675 Blanluet – Portier, Investment Funds, 75-76.

676 Blanluet – Portier, Investment Funds, 75.

677 As regards interest income, the difference is less significant. However, the investor of a French investment fund, but not of a foreign investment fund, may elect to have French-source interest income subject to a final tax at source (*prélèvement libératoire*) at a flat rate, as opposed to having such income taxed at the progressive rate. Generally speaking, this would result in a lower tax burden of French-source interest income when received through a French investment fund, as compared to a foreign investment fund.

when derived through the French SICAV[678] and the Luxembourg SICAV. The tax relief in respect of French-source dividend is assumed to be already exhausted.

Table 7. Resident Investor: FRA SICAV with French Dividend vs. LUX SICAV with French Dividend.

		FRA SICAV with FRA dividend	LUX SICAV with FRA dividend
	Investment level		
A	Dividend payment	100	100
B	Withholding tax (statutory rate)	n.a.	25
	Fund level		
C	Taxable income	n.a.	n.a.
D	Corporate tax liability	n.a.	n.a.
E	Tax credit (avoir fiscal)	n.a.	n.a.
F	Distributed income[679]	100	75
	Investor level		
G	Income received	100	75
H	Tax credit	50	n.a.
I	Taxable income	150	75
J	Tax liability (at 40%)	60	30
K	Tax credit	50	n.a.
L	Tax due (J-K)	10	30
M	Net income (G-L)	**90**	**45**
N	Total tax rate (A-M)	10	55

The higher net dividend earned by the French investor in the French SICAV, as compared to the Luxembourg SICAV, derives both from the absence of *avoir fiscal* in the latter case and from the withholding tax levied at source on French-source dividends paid to the Luxembourg SICAV. Should the tax relief in respect of French-source dividends not have been exhausted, the whole amount of dividend would of course be exempt from income tax, while the dividend through the Luxembourg SICAV would be taxable as normal.

[678] The same result would be achieved by using the FCP as an example.
[679] Possible deductible expenses as well as the subscription tax of 0,05 per cent in Luxembourg are not taken into account in the following examples for reasons of simplification.

Another difference between investments through the French SICAV and through a foreign investment fund follows from the different treatment of withholding taxes paid by the investment fund itself on income received from third countries. In accordance with the transparency principle, the credit for foreign withholding taxes may be transferred to underlying investors of the French SICAV, but not to investors of foreign investment funds. The outcome is described in the following chart.

Table 8. Resident Investor: FRA SICAV with German Dividend vs. LUX SICAV with German Dividend.

		FRA SICAV with GER dividend	LUX SICAV with GER dividend
	Investment level		
A	Dividend payment	100	100
B	Withholding tax (treaty rate)	15	15
	Fund level		
C	Taxable income	n.a.	n.a.
D	Corporate tax liability	n.a.	n.a.
E	Tax credit	n.a.	n.a.
F	Distributed income	85	85
	Investor level		
G	Income received	85	85
H	Tax credit (treaty rate)	15	n.a.
I	Taxable income	100	85
J	Tax liability (at 40%)	40	34
K	Tax credit	15	n.a.
L	Tax due (J-K)	25	34
M	Net income (G-L)	**60**	**51**
N	Total tax rate (A-M)	40	49

The two examples above also suggest that it is always more favorable for the French investor to receive French-source dividend, rather than foreign-source dividend, through a domestic investment fund. This follows from the flow-through of *avoir fiscal* and the tax relief in respect of such dividends. On the other hand, it must be noted that the above examples presume that the French investment fund distributes that income, in respect of which the investor is entitled to tax relief. In the case of accumulation of income, the

only difference in the tax burdens would derive from the different rates of withholding tax (if any) applied to income received by the French and foreign investment fund, respectively, since tax relief and credits in respect of income received through the former are not available for the investor.

Resident vs. non-resident investor. For the purposes of comparing the tax treatment of non-resident investors to resident investors in French investment funds, a distinction must be drawn between the SICAV and FCP. From the perspective of non-resident investors, the SICAV is treated as an intransparent entity – in other words, the principle of transparency applicable to resident investors of the SICAV is not extended to non-resident investors. Therefore, a distribution paid by the SICAV to a non-resident shareholder is generally classified as dividend for French tax purposes, though there are some minor exceptions in favor of non-resident investors.[680] However, tax credits attached to the income received by the fund are also made available to non-resident investors, although the amount of tax credits is limited to 1/3 of the net dividend. The use of such credits also requires that a distribution be paid to the non-resident investor by the SICAV. Therefore, it is arguable that availability of tax credits is not of particular significance, since non-resident investors will usually place their money into the shares of accumulating SICAVs, in order to avoid the whole withholding tax on the distribution in France.[681]

In the case of the FCP, the principle of transparency is also applicable to non-resident investors. However, it is arguable that this tends to work to the disadvantage of non-resident investors. In the first place, as far as the reduction of French withholding tax on dividend and the transfer of *avoir fiscal* are concerned, it is up to an individual investor to claim any benefits provided for by the tax treaty between the state of residence and France, as if the investment had been made directly in shares of French companies. Secondly, tax credits – in respect of foreign-source income provided by tax treaties between France and the source states of income – are not available to non-resident investors. Instead, a non-resident investor of the FCP may, in accordance with the transparency principle, rely on provisions of tax treaties between the state of residence and the source state of income. In practice, individual claims by non-resident investors are precluded by disproportionately burdensome administrative procedures.[682]

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[680] See Blanluet – Portier, Investment Funds, 74.
[681] See Blanluet (1997) 437.
[682] See Blanluet (1997) 439.

5.5 Finland

5.5.1 Resident Investor in Domestic Fund

On account of the tax exemption conferred on the Finnish investment fund (*sijoitusrahasto*), the income earned by the fund will be taxed solely in the hands of underlying investors. Since the Finnish investment fund is treated as a separate taxable entity for tax purposes and the TVL does not require the income to be distributed annually, the taxation of income can be deferred until the distribution of income to the investor or disposal of units by the investor. Typically, Finnish fund management companies provide investors with the possibility of choosing between 'income units' (*tuotto-osuus)*, on which income is distributed periodically and 'growth units' *(kasvuosuus)*, on which income is accumulated within the fund.

A distribution by the investment fund to a resident unit-holder is classified as 'profit share' (*voitto-osuus*) and treated as capital income.[683] Therefore, the original character of income received by the fund does not remain when the income is redistributed to unit-holders. From the perspective of applicable tax rates, this is of no relevance since dividend, interest and capital gains are all taxed at the flat rate of 29 per cent.[684] When paid to an investor, the profit share is subject to a final withholding tax of 29 per cent.

In Finland the imputation credit system is applied, but, as mentioned, it will be abolished as from 2005. The Act on Imputation Credit (YHL) excludes investment funds and their distributions from the scope of the system.[685] Therefore, the underlying investors of Finnish investment funds are not entitled to an imputation credit in respect of a distribution, *viz.* profit share. Since the original character of income does not remain when distributed to investors, imputation credit is not available, even if a distribution consists partly of Finnish-source dividends (no flow-through of income). As a result, treatment of Finnish-source dividends received through investment funds has been less favorable than when received by way of a direct investment in the same shares by the resident investor.[686] In the wake of the abolition of imputation credit system the difference between direct and fund investments in this respect will disappear.

[683] TVL § 32.
[684] From 2005, the tax rate for capital income will decrease to 28 per cent.
[685] YHL § 2, according to which the YHL will not be applied to tax-exempted corporations.
[686] However, it must be noted that the tax may be deferred by accumulating dividend within the fund, which is an advantage as compared to a direct investment.

Table 9. Domestic-source Dividend: Direct Investment vs. Investment through a Fund.

	Direct investment	Investment through a Fund
Net dividend	100	100
Imputation credit[687]	40,85	0
Gross dividend	140,85	100
Tax due	40,85	29
After-tax dividend	100	71

The imputation credit system will be replaced by a system based on a partial-exemption of dividend income in the hands of resident individual investors. In accordance with the new dividend tax system, only 70 per cent[688] of dividend income received from a publicly-listed company is taxable capital income, whilst the rest 30 per cent constitute tax-exempt income for the investor.[689] However, the partial-exemption is not applicable to the profit share received from the investment fund, because under Finnish tax laws this does not constitute dividend. Therefore, even after the abolition of the imputation credit system, there will remain difference in tax treatment between dividends received directly and through the investment fund for Finnish individual investors.

Withholding taxes levied on foreign-source income received by the Finnish investment fund are not creditable at the fund level, owing to the absence of any tax liability against which the foreign taxes could be credited. As for underlying investors, there are no specific rules which would facilitate the transfer of foreign tax credits to the investor level. Nor can underlying investors of Finnish investment funds rely on provisions of the relevant tax treaty between Finland and the source state of income. This is because, from a Finnish perspective, the investment fund is the beneficial owner of the income for tax treaty purposes. It seems also that investors of Finnish investment funds cannot rely on the rules of the Act on Elimination of International Double Taxation (MenetelmäL). Based on the wording and purpose of the MenetelmäL, three conditions must be met by a person to be eligible for tax credit: (1) the recipient of income and the person entitled to credit is the same taxpayer[690]; (2) the taxable income in respect of which the foreign tax is to be

[687] Imputation credit equals 29/71 of net dividend.
[688] During the transitional period of 2005, the taxable amount is 57 per cent.
[689] See HE 92/2004.
[690] See HE 76/1995, detailed arguments, 1.4.3 §.

credited corresponds to the income on which the creditable tax was originally levied[691]; and (3) the taxable year in which the credit is granted corresponds to that in which the creditable tax was levied on income[692]. It has been argued that there are at least two obstacles to the crediting of foreign taxes at the level of investors. Firstly, the second condition above is not fulfilled, as it is extremely difficult to prove that the income on which the tax is paid abroad is the same as that received by the unit-holder in the form of a profit share.[693] Secondly, in accordance with the aim of the MenetelmäL to eliminate the juridical double taxation, as opposed to economic double taxation, a credit for foreign taxes can only be given to that same taxpayer who has borne the tax abroad. When it comes to Finnish investment funds and their investors, the requirement that the taxpayer be the same, cannot be fulfilled since Finnish investment funds are not treated as transparent for Finnish tax purposes.[694]

Capital gain realized on the redemption[695] of units will be taxable as capital income at the same flat rate of 29 per cent as the profit share. When determining the amount of taxable capital gain, the investor may optionally deduct either the real acquisition cost of the unit, or alternatively a presumptive cost of either 20 per cent (ownership < 10 years) or of 50 per cent (ownership ≥ 10 years) of the redemption price.[696]

The tax treatment of switches between sub-funds of an umbrella fund is not of significance in respect of Finnish investment funds because the SijRL does not permit the structure. On the other hand, as noted earlier, the management company may opt for having two different classes of unit, in terms of distribution policy, within the same investment fund. It is also possible for the investor to switch from one type of unit to the other. The TVL does not contain any specific rules on the tax treatment of switches between unit classes for capital gains tax purposes. In the advance ruling KVL 8.6.1998 N 102, the Central Tax Board (KVL)[697] stated that the switch between income and growth units of the same investment fund does not give rise to a disposal for capital gain tax purposes. The reason for this is that the switch between unit classes does not require either redemption by the management company or subscription by the unit-holder, but only a registration of a transfer from one

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[691] MenetelmäL § 3(1).
[692] MenetelmäL § 3(1).
[693] Heiniö (1997) 414; Vapaavuori (1998b) 493.
[694] See Vapaavuori (1998b) 492-493.
[695] The same applies to other disposals.
[696] TVL § 46.
[697] Resident and non-resident taxpayers may apply for a binding advance ruling in income and wealth tax issues from the competent tax authority. The Central Tax Board issues such rulings on matters which are considered to be important and which may set a precedent, or which are of significant value to the applicant. See Helminen (2002a) 334.

unit class to the other. Therefore, there occurs neither any return of capital to the investor nor an additional investment by the investor.[698]

Despite the absence of the umbrella fund structure in Finland, it has been challenged as whether the switch between two investment funds administered by the same management company could not be regarded as constituting disposal for capital gains tax purposes. The Supreme Administrative Court (KHO) in the decision KHO 10.05.2000/862 ruled that the switch from one investment fund to another, albeit managed by the same fund management company, constitutes a disposal for tax purposes and thus gives rise to capital gains taxation in accordance with TVL § 45(1) and TVL § 110(2):

> If a taxpayer exchanges wholly or partly his income or growth unit in an investment fund administered by a fund management company for another income or growth unit in a fund that is also administered by the same fund management company, there will be a disposal, and the gain constitutes taxable 'capital income' for the taxpayer. KHO 10.05.2000/862.

5.5.2 Resident Investor in Foreign Fund

The TVL does not contain any special rules for the taxation of investments in foreign investment funds. So far, the absence of specific rules may not have been considered problematic, because most of the investments by Finnish individual investors have been made in domestic investment funds[699]. Nevertheless, the growing importance of foreign investment funds as a means of cross-border investment may bring changes in the future. In the absence of specific tax rules, distributions and capital gains on units or shares of foreign investment funds are, as a rule, treated according to the same principles as are distributions and capital gains on units of Finnish investment funds.

Under TVL § 32, a profit share from the investment fund is treated as capital income. As the section does not distinguish between distributions from domestic and foreign investment funds, it seems that both are treated similarly in the hands of the Finnish investor. Hence, at least distributions from foreign investment funds comparable to Finnish investment funds are classified as profit share for Finnish tax purposes, and taxed in the hands of resident investors as capital income at the flat rate of 29 per cent.[700] If the legal form, or the tax treatment, of a foreign investment fund does not correspond to that of a Finnish investment fund, the tax treatment of income from a foreign

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[698] For the referred advance ruling, see Linnakangas et al. (1998) 92-96.
[699] See *Taloussanomat* 2 June 2001.
[700] See Vapaavuori (1998b) 494; Helminen, Kansainvälinen verotus, 9:47.

investment fund would depend on how the latter is classified for Finnish tax purposes.[701]

A foreign entity is classified, for Finnish tax purposes, primarily by comparing the company law characteristics of the foreign entity with those of Finnish domestic entities. The tax treatment in the residence state of the foreign entity is not decisive, but may have some impact on the assessment in borderline cases.[702] The entity classification would in principle determine both the taxable event and the income type of a distribution in the hands of the Finnish investor.

In terms of taxable event, the TVL distinguishes between corporations (TVL § 3) which are treated as taxable (intransparent) entities separate from the underlying participants and partnerships (TVL § 4) which are transparent entities for tax purposes. This means that Finnish investors in foreign partnerships are taxed yearly on their respective share of the partnership's income[703], irrespective of any distribution, in contrast to shareholders of foreign corporations, which are generally taxed only at the moment of an actual distribution[704]. Classification as partnership would therefore result in the annual taxation of income arising within a foreign investment fund in the hands of underlying Finnish investors.[705]

The classification of the foreign investment fund must be made by comparing its company law form with entities enumerated in TVL § 3 as corporations and TVL § 4 as partnerships. TVL § 3 refers, inter alia, to the company limited by shares, *viz. osakeyhtiö,* and the investment fund, *viz.* s*ijoitusrahasto*. In addition, TVL § 3(7) states that any other entity comparable to the entities referred to in TVL § 3(1-6), or assets reserved for a special purpose, will also be treated as a corporation for tax purposes. Therefore, non-resident corporate form investment funds, such as companies with variable capital, qualify as corporations.[706] Even if the foreign investment fund were to lack legal personality, it could still qualify as a corporation, on the ground that it is comparable to the Finnish investment fund, or could at least be regarded as assets reserved for a special purpose.

Owing to the fact that the company law form of a non-resident entity is the decisive factor in the entity classification, and that the broad wording of TVL § 3(7) seems to allow the inclusion of foreign investment funds in its scope, it is arguable that non-resident investment funds may be treated as separate

[701] See Helminen, Kansainvälinen verotus, 9: 48.
[702] For entity classification in Finland, see Helminen (1999a) 112-113.
[703] See TVL § 16a.
[704] An exception is made if the income of a foreign entity is attributed to a Finnish investor under the CFC legislation.
[705] See Helminen, Kansainvälinen verotus, 6: 13.
[706] See Heiniö (1997) 412.

taxable entities (corporations) for Finnish tax purposes, apart from the cases where the investment fund activity is clearly carried out in a partnership form. The two advance rulings of the Central Tax Board seem to confirm this view. In the more recent ruling, the Central Tax Board held that the Luxembourg FCP is comparable to the Finnish investment fund on account of the similar characteristics and operations of the two entities.[707] This view could also be supported by the principle of tax neutrality, so that Finnish investors in foreign investment funds should be treated in accordance with the same tax principles as those in domestic funds.[708] On the other hand, in an earlier advance ruling[709], involving a general partnership, resident in Jersey, which carried on investment activity, the Central Tax Board held that the fact that the foreign entity was called a 'fund', in the sense that its activities were similar to the Finnish investment fund, could not as such make the entity comparable to the Finnish fund for Finnish tax purposes.

As for the classification of distributions from foreign investment funds, the starting point is TVL § 32, which states that a profit share is to be treated as income from capital. As TVL § 32 does not expressly refer to either the Finnish investment fund, *viz. sijoitusrahasto,* or to a foreign investment fund, profit shares from both could be classified as 'profit share' within the meaning of the section. If this were not the case, a profit distribution by a foreign investment fund could be classified either as 'other income from capital' under TVL § 32[710] or alternatively as 'dividend from a non-resident company' under TVL § 42(1)[711]. The latter case would arise only insofar as the foreign investment fund was established in the company form. However, it seems that, in accordance with the advance ruling KVL 17.4.1999 N 72 of the Central Tax Board (KVL), even profit distributions by investment funds established in a

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[707] KVL 8/2003. The ruling is subject to appeal in the Supreme Administrative Court (KHO).
[708] See Vapaavuori (1998b) 493.
[709] KVL 1997/5. For details of the case, see discussion below concerning credit of foreign taxes.
[710] In this case, there would be no difference in tax treatment, because the income would be taxable under TVL § 32 in exactly the same way as if the income were classified as profit share.
[711] The consequence of treating the distribution as dividend income from a non-resident company would be that the income should be divided for tax purposes into two parts as follows: 13,5 per cent of the value of unit at the end of the year preceding the distribution would be regarded as capital income and would be taxed under TVL § 32 at the flat rate of 29 per cent. The rest of the distribution, if any, would be taxed as earned income at the recipient's progressive income tax rate. See TVL § 42(1). In practice, the amount of a distribution would rarely account for more than 13,5 per cent of the value of unit. This means that the tax treatment would be the same in spite of different classification. However, the changes in tax laws effective from 2005 will make the matter more complicated. The similar treatment of foreign-source dividends with domestic-source dividends is made dependent on the distributing company being either a qualifying entity within the meaning of the Parent-Subsidiary Directive or an entity to which the relevant tax treaty can be applied. In many cases, it is subject to interpretation whether this is the case. Should the investment fund not qualify as one of the abovementioned entities, the dividend from the investment fund would qualify as earned income and be subject to progressive tax rate in the hands of the resident investor.

corporate form (here a Luxembourg SICAV) will be classified as a profit share under TVL § 32:

> [….] A profit share paid to the unit-holder X in a sub-fund of the AB SICAV in the form of cash or new units constituted a 'profit share' as meant in TVL § 32.[712] KVL 17.4.1999 N 72.

In the rare case that a foreign investment fund would be treated as a partnership for Finnish tax purposes, the income received by the fund would be taxed directly in the hands of the Finnish investor, in accordance with the original items of income.[713]

As regards foreign tax credits, withholding taxes imposed on profit distributions by non-resident investment funds are treated similarly to those imposed on any other portfolio income. They readily fulfil the formal conditions laid down in the MenetelmäL and are credited against a Finnish investor's tax liability on the income in Finland.[714] However, the Finnish investor in a foreign investment fund is not, as a rule, able to credit any withholding taxes suffered by the investment fund in the source state of income. As in the case of Finnish investment funds, this results from the fact that the conditions for a credit of foreign taxes in the MenetelmäL are not met, since the foreign investment fund is treated as a separate tax subject from the Finnish investor.[715] This would be otherwise only if the foreign investment fund were treated as a transparent entity for Finnish tax purposes. In light of the advance ruling KVL 1997/5 of the Central Tax Board, this is the case only if investment fund activities are clearly carried on in a legal form corresponding to the Finnish partnership:

> B Fund L.P. ('Fund') is a limited partnership established under the laws of Jersey Island and registered therein. Fund does not have any branch in Finland. The general partner of Fund is M. Ltd from Jersey. As limited partners, there are investors from different states and A Oy from Finland. Fund's purpose is to make investments, among others, in companies in Estonia and Latvia. The income received by Fund may comprise dividend, interest or capital gains. Insofar as Estonia or Latvia levies a withholding tax on the above-mentioned income, A Oy is allowed to deduct the amount of taxes paid in Estonia or Latvia from the taxes that will be levied on its part of income from B Fund L.P. to the extent these consist of the same income. The credit may not exceed the amount of taxes payable on the same income in Finland. KVL 1997/5.

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[712] For the details of the case, see the discussion below concerning switches between sub-funds of an umbrella fund.
[713] See Helminen (2002a) 215; Helminen, Kansainvälinen verotus, 9:48.
[714] See the discussion in the preceding section.
[715] See the discussion in the preceding section.

In practice, the more common situation for Finnish investors in foreign investment funds is to realize the income in the form of capital gains, rather than receiving a profit distribution. Finnish tax law does not contain any specific rules on the taxation of capital gains on units or shares of foreign investment funds; consequently, capital gains realized on the redemption or sale of units or shares of foreign investment funds are taxed in exactly the same way as capital gains on units of domestic investment funds. Therefore, according to TVL § 32, capital gain is treated as capital income and taxable at the flat rate of 29 per cent to an individual unit-holder.[716] In the computation of the amount of capital gain, the investor may optionally deduct either the real acquisition cost of the unit, or a presumptive cost of either 20 per cent (ownership < 10 years) or 50 per cent (ownership ≥ 10 years) of the unit's redemption price, depending on the time of ownership (in brackets).[717]

The treatment of switches between sub-funds of an umbrella fund is not addressed in Finnish tax law. On account of the absence of the umbrella fund structure in the Finnish legislation, it is not clear as how to treat a switch between sub-funds for capital gains tax purposes in Finland. The main issue is whether a switch constitutes a disposal for capital gains tax purposes, thereby triggering the taxation for the Finnish investor.

The Central Tax Board has had difficulties in determining whether or not the switch from one sub-fund to another within an umbrella fund is treated as a disposition for capital gains tax purposes. First, in the advance ruling KVL 1989 N 556, it took the stand that the switch of units between sub-funds constitutes a disposal. However, in the more recent ruling KVL 17.2.1999 N 72, the switch between different sub-funds was not treated as a disposal, and hence capital gain or loss was not realized based on the transaction:

> AB SICAV is a Luxembourg fund […] The fund was a so-called umbrella fund, which means that the fund has sub-funds, each having their own assets and investment objects determined beforehand. […] Investors have the right to switch their units from one sub-fund to another. […] Within a sub-fund of AB SICAV there may be both growth and income units. In case a unit-holder wishes to exchange, for example, his income unit for a growth unit, the exchange is technically carried through so that the fund redeems the unit-holder's income unit and correspondingly issues a growth unit. The redeemed income unit is not resold but cancelled. The unit-holder does not invest any new capital in the course of the exchange and no capital is

[716] However, if units are deemed to belong to the individual's source of business income, tax treatment is different. Broadly speaking, in this case the whole selling price is treated as taxable income and the acquisition cost of the unit is deductible irrespective of the length of ownership.
[717] TVL § 46.

> returned to him. A person X has invested his money in a sub-fund of the AB SICAV. 1) […] 2) An exchange between classes of units within a sub-fund did not realize any capital gain or loss in X's taxation in case X, in accordance with the fund rules, exchanged a A-class income unit wholly or partly for a B-class growth unit, or vice versa. 3) An exchange of a unit in one sub-fund wholly or partly for a unit in another sub-fund did not constitute such a disposal which realized a capital gain or loss in X's taxation. KVL 17.2.1999 N 72.

When it comes to the switch between different unit classes of a sub-fund, the above ruling follows consistently the tax treatment in the case of domestic investment funds. However, in light of the decision KHO 10.05.2000/862 by the Supreme Administrative Court, the outcome may be seen as somewhat surprising. It seems that the Central Tax Board has equated the switch between unit classes with the switch between different sub-funds, owing to the similar technical nature of both transactions. It is also possible that it has paid attention to the principle of a single legal entity, which is satisfied by the SICAV, while the Finnish counterpart, i.e. two investment funds managed by the same company, was not sufficient to constitute a single legal entity within which a switch without tax consequences may take place.[718] However, in view of the economic substance of both the transactions and the principle of tax neutrality, the ruling may be criticized.

As for economic substance, the following remarks may be made. Firstly, in both cases a switch comprises two different transactions; the management company redeems the 'old unit' in one (sub-) fund from the investor, and then the investor receives a 'new unit' in another (sub-) fund. Secondly, the underlying instruments in which the unit-holder participates, prior to the switch and after the switch, are different in both the cases. Third, in both the cases, no capital is returned to the unit-holder, nor is any new capital invested, as the old units are only converted to the units in the ratio of the respective unit prices, the matter which seems to have been the decisive factor in KVL 8.6.1998 N 102 and KVL 17.2.1999 N 72. In KHO 10.05.2000/862, however, it was not considered to prevent the realization of capital gain.[719]

Indeed, it has been suggested that a switch between Finnish investment funds should not give rise to capital gains taxation, insofar as the relevant funds are managed by the same Finnish fund management company in a similar manner as are umbrella funds, both transactions being similar from the point of view of economics.[720] Moreover, it is already possible to make a

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[718] See also Immonen (2001) 145.
[719] See Immonen (2001) 145.
[720] See Tikka – Haapaniemi (1999) 357.

switch between different Finnish investment funds in connection of life assurance or pension policies, the premiums of which are placed into investment funds as chosen by the policy-holder (so-called ‘unit linked policies’)[721]. However, it is also possible to come to an opposite conclusion, so that a switch between sub-funds of an umbrella fund – as with switches between Finnish investment funds – should trigger capital gains taxation. The rationale for treating a switch between sub-funds or between separate Finnish investment funds as a disposal is that each of the (sub-) funds has its own assets and earnings thereon, as well as its expenses, separate from the other (sub-) funds. Although an umbrella fund constitutes a single entity in legal terms, unit-holders in a particular sub-fund have, in effect, restricted their participation in the financial result of the sub-fund in question, and do not participate in the total financial result of the umbrella fund.[722] As a result, for Finnish tax purposes, the umbrella fund would be regarded as transparent and the ownership in sub-funds would be decisive. From a pragmatic point of view, it must nevertheless be noted that efficient taxation of capital gains in connection of switches between sub-funds of an umbrella could turn out to be difficult.[723]

5.5.3 Non-Resident Investor in Domestic Fund

In accordance with TVL § 9, a non-resident person is taxable only on income arising from sources within Finland (limited tax liability). Under TVL § 10(9), a profit share from the Finnish investment fund is treated as income derived from Finnish sources. According to LähdVL § 2(1) (Act on the Taxation of Non-residents’ Income and Capital) the taxation of non-resident persons will be effected by withholding a final tax at source. Under LähdVL § 3(2), the same rules as for dividends are applicable to the profit share of an investment fund.[724] Consequently, a withholding tax of 29 per cent will be levied on profit shares paid out to non-resident persons, subject to tax treaty provisions.[725]

In the case of an applicable tax treaty between Finland and the residence state of the investor, a reduced withholding tax rate may be applicable.

[721] For unit-linked policies, see Ossa (1999) 27.
[722] As a result, the issue and redemption price, for example, are determined separately for each fund by dividing the net asset value of the fund in question by the number of outstanding units in such fund.
[723] See Tikka – Haapaniemi (1999) 357.
[724] It should be noticed that the equation of ’profit share’ with ’dividend’ does not mean that the concept of dividend would include also profit share. Under Finnish tax law, a profit share by an investment fund is not considered as equivalent to dividend. The imputation system, for example, is not applied to income paid out by investment funds. See Vapaavuori (1998b) 497-498.
[725] LähdVL § 3(1) and 7.

However, the income classification of the profit share of a Finnish investment fund for tax treaty purposes was, until recently, uncertain in Finland. This follows from the fact that neither most of the tax treaties concluded by Finland, nor the OECD Model Convention, contains any specific reference as to which provision the profit share would fall under.[726] Of Finnish tax treaties only the one concluded with Germany addressed the classification of a profit distribution from the investment fund by subjecting it to the dividend article.[727] In the absence of any express reference to the income type of a distribution by the investment fund, the treaty article concerning either 'dividend' or 'other income' could in principle be applied.[728] In 1999, the Supreme Administrative Court in its decision KHO 14.6.1999 T 1600 ruled that, in the absence of any express reference in a tax treaty, the dividend article of the tax treaty will not be applicable to a profit share from a Finnish investment fund.[729]

> A yearly profit share paid to a person resident in Sweden or Canada by a Finnish investment fund was not 'dividend' as meant in the Nordic tax treaty or Finland-Canada tax treaty. KHO 14.6.1999 T 1600.

When the dividend articles are not applicable to a profit share, other income articles of tax treaties concluded by Finland are applicable.[730] The other income article usually allocates the sole taxing right in respect of the income to the residence state of the recipient. As a consequence, Finland does not impose withholding tax on profit shares paid to non-resident investors, unless

[726] See Vapaavuori (1991) 96.

[727] Art. 10(4) of the Finland-Germany tax treaty. It has been the policy of Germany rather than Finland to include an express mention of the profit distribution from an investment fund in the dividend articles of tax treaties.

[728] See Helminen, Kansainvälinen verotus, 9:47. For a thorough discussion on the qualification of distributions by investment funds for tax treaty purposes, see Helminen (1999d) 2162 ff. or Helminen (1999b) 376 ff.

[729] The decision, and in particular the arguments put forward by the KHO, have been criticized by Helminen (1999c) 473 ff. See also Vapaavuori (2000) 84, defending the arguments of the KHO.

[730] Although not expressly mentioned in the ruling KHO 14.6.1999 T 1600, it is likely that the other income articles of tax treaties will be applied by Finland to the profit share of the Finnish investment fund. See Vapaavuori (1999) 324; Helminen (2002a) 214. Generally speaking, one could also consider the alternative, of including the profit share under relevant income articles of a tax treaty, to be in accordance with the original items of income comprising the profit share. See Vogel (1996) 677-678, in respect of dividends paid out by German investment funds. It must however be remembered that Germany adheres to the principle of transparency in terms of the income type. For example, the profit share distributed by an investment fund investing solely in debt-bearing instruments (bond fund) could be classified as interest. However, generally the income of a bond fund may additionally comprise, among other income, capital gains, so that for the described approach to be consistent, other such items of income should be distinguished from interest income, and should be subjected to the relevant income article. See Tikka – Haapaniemi (1999) 59. Furthermore, in practice the described approach would impose a considerable administrative burden on fund management companies, which should provide, for tax purposes, an itemized list of the underlying income comprising the distribution. It would also be inconsistent with the domestic tax treatment of Finnish investment funds, which is not based on the flow-through of income, but rather on the transformation of original income at the fund level to the profit share.

the other income article exceptionally gives the right to levy tax on the income falling under the article[731]. In practice, under the tax treaties between Finland and other Member States of the EU, with the exception of Germany, no withholding tax will be levied on profit shares paid out by Finnish investment funds.[732]

Capital gains on the disposal of shares of Finnish investment funds are taxable, subject to tax treaty provisions, only if the assets of a Finnish residential housing company, a company limited by shares, or a co-operative society consist mainly (> 50 per cent) of immovable property situated in Finland (TVL § 10(10)). It is arguable that, based on the wording, the provision is not applicable to the sale of units in the Finnish investment fund.[733] In any case, the situation described cannot arise with respect to Finnish investment funds, owing to restrictions in investment policy under the SijRL and the UCITS Directive, but only with respect to investment companies focusing on real estate investments.[734]

5.5.4 Evaluation

Domestic vs. foreign investment fund. In Finland, there are no express rules dealing with the taxation of investments in foreign investment funds. As a result, the tax treatment of resident investors in foreign investment funds generally follows the same principles as in the case of domestic funds. For the most part, this is likely to contribute to a neutral tax treatment between domestic and foreign investment fund investments from a Finnish investor's viewpoint. The following tables compare the tax treatment of a Finnish investor in a domestic investment fund to the treatment of a Finnish investor in

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[731] See Helminen, Kansainvälinen verotus, 9:47. For example, Art. 21(2) of the Finland-Canada tax treaty seems to give the source state the possibility of imposing a withholding tax on other income in accordance with its domestic tax law, provided that such income is derived from the sources within that state. Therefore, Finland could impose a withholding tax on the profit share as provided by LähdVL § 3(2).

[732] Under the tax treaties with many other countries, withholding tax may be levied on profit shares. This is the case in the tax treaties with, among others, Canada, Australia, New Zealand and the Baltic Countries. In contrast, on profit shares paid to the United States, Switzerland, Norway and Japan, no withholding tax will be levied. For withholding tax rates on profit shares in Finland, see Verohallitus (2003).

[733] See Andersson – Linnakangas (2002) 29.

[734] For further discussion, see Heiniö (1997) 416-417; Vapaavuori (1991) 92-94. Even if such gains were to constitute Finnish-source income under TVL § (10)(10), the provisions of an applicable tax treaty must be taken into account. Art. 13(1) of the OECD Model Convention gives the source state the right to tax capital gains derived from the alienation of immovable property which is situated in that state. Nevertheless, there are some exceptions to this rule in the tax treaties concluded by Finland. For example, in the Finland-United Kingdom tax treaty such capital gains cannot be taxed in the source state if the shares of the company in question are listed on a stock exchange. See Art. 14(2) of the Finland-United Kingdom tax treaty.

a foreign fund (SICAV) both with respect to domestic-source and foreign-source dividend.

Table 10. Resident Investor: Sijoitusrahasto with Finnish Dividend vs. LUX SICAV with Finnish Dividend.

		Sijoitusrahasto with FIN dividend	LUX SICAV with FIN dividend
	Investment level		
A	Dividend payment	100	100
B	Withholding tax (statutory rate)	n.a.	15
	Fund level		
C	Taxable income	n.a.	n.a.
D	Corporate tax liability	n.a.	n.a.
E	Tax credit	n.a.	n.a.
F	Distributed income[735]	100	85
	Investor level		
G	Income received	100	85
H	Tax credit (treaty rate)	n.a.	n.a.
I	Taxable income	100	85
J	Tax liability (at 29%)	29	24,65
K	Tax credit	n.a.	n.a.
L	Tax due (J-K)	29	24,65
M	Net income (G-L)	**71**	**60,35**
N	Total tax rate (A-M)	29	39,65

[735] Possible deductible expenses as well as the subscription tax of 0,05 per cent in Luxembourg are not taken into account in the following examples for reasons of simplification.

Table 11. Resident Investor: Sijoitusrahasto with German Dividend vs. LUX SICAV with German Dividend.

		Sijoitusrahasto with GER dividend	LUX SICAV with GER dividend
	Investment level		
A	Dividend payment	100	100
B	Withholding tax (treaty rate)	15	15
	Fund level		
C	Taxable income	n.a.	n.a.
D	Corporate tax liability	n.a.	n.a.
E	Tax credit	n.a.	n.a.
F	Distributed income	85	85
	Investor level		
G	Income received	85	85
H	Tax credit	n.a.	n.a.
I	Taxable income	85	85
J	Tax liability (at 29%)	24,65	24,65
K	Tax credit	n.a.	n.a.
L	Tax due (J-K)	24,65	24,65
M	Net income (G-L)	**60,35**	**60,35**
N	Total tax rate (A-M)	39,65	39,65

With respect to a Finnish-source dividend, the difference in tax burden to the disadvantage of the Finnish investor in the SICAV follows from the withholding tax levied in Finland on dividend paid to the SICAV. The withholding taxes are not creditable in Luxembourg for the SICAV, or under the MenetelmäL and the Finland-Luxembourg tax treaty, to the Finnish investor.

With respect to a German-source dividend, the outcome between the investments in the Finnish and Luxembourg funds is neutral for the Finnish investor. This is because the impossibility of obtaining a credit for foreign withholding taxes applies to Finnish investors in both domestic and foreign investment funds respectively.

As regards capital gains taxation, it was noted that the switch between sub-funds of an umbrella fund may apparently be made without tax consequences in Finland. However, in the absence of the umbrella fund structure in Finland, a switch between Finnish investment funds is not possible without triggering capital gains tax at the investor level. In principle, this puts those investment

funds established in jurisdictions allowing the umbrella fund structure in an advantageous position over Finnish investment funds, from the perspective of Finnish investors who wish to manage actively fund investments.

Resident vs. non-resident investor. The tax treatment of resident investors, in comparison with non-resident ones in Finnish investment funds, seems not to differ. Only with respect to withholding taxes levied on profit shares paid by Finnish investment funds are resident and non-resident investors governed by different sets of rules. Distributions to resident investors are subject to a final withholding tax of 29 per cent, whereas non-resident investors may generally rely on tax treaty provisions, with the frequent result that no withholding tax is levied on the distribution.

6 INVESTMENT FUND INVESTMENTS AND TAX ENFORCEMENT

6.1 Introduction

Apart from substantive tax rules, the tax treatment of an investment fund investment in the residence state of the investor depends on the enforcement of such tax rules. The efficiency of taxation may vary considerably, depending on whether an investment is made into a domestic or foreign investment fund by the resident investor. Basically, the difference stems from the fact that, while in the former case the source of income lies within the legislative and executive powers of the jurisdiction, in the latter case it lies outside the sovereignty. Therefore, the residence state's ability to set a necessary legislative framework for tax control, and to enforce taxation, is essentially greater in the national context than in the cross-border context.

The differences in the effectiveness of tax control lead inevitably to differences in taxpayer compliance. While for income from national transactions taxes are, as a rule, effectively paid by taxpayers and collected by tax authorities, for income from cross-border transactions taxes may be more easily avoided by taxpayers, the tax authorities of the residence state being unable to prevent such avoidance solely through national tax control measures.

For the purposes of this study, the most interesting issue is the possible differences in the efficiency of tax enforcement between domestic and cross-border investment fund investments, and the impact of such differences on the tax neutrality of investment fund investments within the European Union. From the perspective of the residence state of the investor, the intended outcome of taxation under substantive tax legislation will not be attained if, whilst income from domestic investment funds is effectively taxed, income from foreign investment funds may escape taxation.[736]

In the following, the tax enforcement of domestic investment fund investments is first discussed. Then the discussion turns to the tax enforcement measures available for cross-border investment fund investments. Generally speaking, measures may be relied on at three legislative levels. In the first

[736] There are also other harmful consequences resulting from inefficient tax enforcement, such as erosion of national tax bases, changes in the structure of taxation, or violation in the principle of equity of taxpayers. See, for example, OECD (1998) para. 23.

place, Member States may have enacted national measures aimed at ensuring the taxation of income from foreign investment funds in the hands of resident investors. Secondly, the newly adopted Savings Tax Directive will enhance the tax control of cross-border interest income paid within the Community to individual investors. Importantly, the Savings Tax Directive generally also covers the income received through investment funds. Finally, there are available other forms of international co-operation in the field of tax control. The focus of the discussion will be on the international exchange of tax information, which constitutes one form of mutual administrative assistance between states. The reason for limiting the discussion to exchange of information is that not only is it considered as the cornerstone of international co-operation in the field of tax control[737], but also, among the forms of mutual administrative assistance, it has by far the greatest significance in the tax control of international portfolio investments. [738] Finally, conclusions regarding the differences in tax enforcement by the Member States, in the context of domestic and cross-border investment fund investments respectively, are drawn.

6.2 Tax Enforcement of Domestic Investment Fund Investments

In accordance with the principle of worldwide taxation, or residence-based taxation, the resident taxpayer is liable to tax on all income, irrespective of whether derived from domestic or foreign sources. In most countries, the cornerstone of the implementation of worldwide taxation is the taxpayer's duty to disclose the taxable income, irrespective of its source, by filing an annual tax return with the residence state tax authorities.[739] However, it is also possible to ensure the taxation by way of levying a final withholding tax at source on the income, which in effect satisfies the tax liability of the resident investor on the income.[740]

The effective implementation of tax laws in a system based on a taxpayer's own declaration requires the tax authorities to be able to control the accuracy

[737] See, for example, Calderón (2000) 464.
[738] Other forms of co-operation, such as tax investigations, are generally not of relevance for international portfolio investments. However, if portfolio investment activity were carried out, for example, by means of a private investment company, tax investigations could also be of relevance. See Juusela (1998) 298.
[739] See Juusela (1998) 216-217.
[740] This is the case in Belgium. In the case of a non-corporate investment fund the final withholding tax is levied already when the income is paid to the investment fund. In the case of the SICAV, the withholding tax is levied when the income is paid out to the investor. See Koen, Investment Funds, 52-53.

of the information provided by the taxpayer.[741] The effective verification of information may be ensured by also obliging any third party involved in a transaction to report tax relevant information automatically to tax authorities. At the same time, the awareness of automatic reporting requirements can effectively increase voluntary compliance with tax laws by investors.[742] In view of investment fund investments, automatic information requirements may in principle be imposed on the payer of income, whether this may be a distribution or redemption proceeds, or on any other party in its capacity as a service provider (investment fund, management company, depositary). Third parties may also be obliged to provide information at the specific request of tax authorities.

Where the investment fund, as well as the investor, is resident within the same jurisdiction, there are extensive opportunities for national tax authorities to enforce the taxation of income arising from the investment to the resident investor. Even the problem of identifying foreign-source income, which the tax authorities confront in the case of a direct investment, does not arise when the foreign-source income is received through a domestic investment fund.[743] While the duty of taxpayers to file a tax return is the basis of the tax enforcement system, there are also extensive opportunities to impose reporting duties on investment funds, or their management companies, which reside in the same jurisdiction, as well as on any payers of income or paying agents through which income is paid out. In the presentation below are laid out specified requirements concerning tax reporting and the withholding of a tax imposed on resident investment funds or, as the case may be, on other related parties such as the management company, depositary and the paying agent.

The United Kingdom. As with other UK companies, UK investment funds are required to file an annual tax return, together with detailed corporation tax computations. In the case of a distribution, UK investment funds are obliged to issue to the recipient a voucher showing the amount of the distribution, the date of the payment and the amount of the tax credit attached to the distribution.[744] In the case of an interest distribution, a withholding tax must be levied in a case where the recipient is resident in the United Kingdom.

Germany. German investment funds are under a comprehensive obligation to notify investors of the amount and composition of the income taxable in the hands of underlying investors, and to publish such information in the German Official Gazette (*Bundesanzeiger).*[745] With respect to distributed and

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[741] See Juusela (1998) 186.
[742] OECD (2000) 30.
[743] See Juusela (2003) 28.
[744] For more details, see Smith – Turner, Investment Funds, 85-89.
[745] InvStG § 5.

accumulated dividends and accumulated interest income, the investment fund is also obliged to impose withholding tax on the income.[746] In the case of a distribution of interest income, the liability to levy a withholding tax is on the German paying agent.[747]

France. The manager or depositary of a French investment fund must file an annual tax return on behalf of the latter, indicating the aggregate amount of repurchases of units or shares exceeding a certain value per investor, and the value of yearly contributions made by the investor into the fund. Moreover, the management company must file an annual declaration of the amounts paid as distributions to underlying investors of the investment fund. At the request of tax authorities, a detailed breakdown must be made of the income (and the tax credits related thereto) earned by the French investment fund over the business year, irrespective of whether the income was distributed or accumulated. Tax authorities may also avail themselves of the right to demand the disclosure of accounting documents or the identities of investors within the last six years.[748] In France, banks are also subject to a comprehensive obligation to automatically report all tax relevant information with respect to all income from capital to the tax authorities.[749]

Finland. Despite their tax exemption, Finnish investment funds are obliged to supply the tax authorities with detailed information of the assets and liabilities.[750] The information is gathered for the purposes of controlling information declared by investors.[751] Finnish investment funds are also obliged to report profit shares paid out to investors, as well as redemptions by investors, to the Finnish tax authorities.[752] The management company must also impose withholding tax on any distribution paid out by the investment fund.

Luxembourg. Luxembourg investment funds are, for the purposes of the subscription tax, obliged to file a tax return indicating the aggregate value of the net assets. Otherwise, there are no other requirements on the part of investment funds concerning tax reporting.[753] Luxembourg investment funds are at present not liable to withhold tax on distributions. However, as will be

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[746] InvStG § 7(3)-(4).
[747] InvStG § 7(1)-(2).
[748] See Blanluet – Portier, Investment Funds, 54.
[749] See OECD (2000) 72. In fact, France has developed one of the most comprehensive systems of tax reporting in Europe. Sometimes, this has also been regarded as a competitive disadvantage for the French financial institutions: see de la Mettrie (2001) 21.
[750] Decree on Assessment Procedure § 1 (*Asetus verotusmenettelystä).*
[751] Heiniö (1997) 411.
[752] VML § 15 in conjunction with VeroHp 17.1.2000/24 §§ 10 and 13 (Order of National Board of Taxes).
[753] See Beltjens, Investment Funds, 52-53.

discussed later in this chapter, the implementation of the Savings Tax Directive is liable to bring some changes to this.

6.3 Tax Enforcement of Cross-Border Investment Fund Investments

6.3.1 National Measures

It follows from the principle of sovereignty that a state's ability to impose automatic or other kinds of reporting requirements on resident taxpayers' transactions, is generally limited to third parties established within the same jurisdiction. This means that the effective verification of information may generally be ensured through national measures only insofar as payments are effected by domestic payers, or are otherwise received through domestic paying agents, or when transactions are carried out by financial services providers established in the state. In contrast, for cross-border portfolio investments, and to the extent that no domestic third parties are involved, national measures are generally inadequate to ensure tax compliance by resident investors through the verification of the information provided by investors. As a result, the correct identification of foreign-source income earned by resident taxpayers often calls for international cooperation in the field of tax control.

When only the investor but not the investment fund is resident within the taxing jurisdiction, there are few possibilities for tax authorities (apart, that is, from the voluntary declaration of income by the investor) to enforce the taxation of income arising from the investment in a foreign investment fund. The verification of the information supplied by the investor is, as a rule, also more difficult since the investment fund and other service providers are typically established in another jurisdiction. Similarly, the payer of income may reside outside the jurisdiction, though the payment may also be effected through a paying agent established within the jurisdiction.

While some of the Member States have under domestic law imposed tax reporting requirements on foreign investment funds which distribute their units for resident investors of the Member State, others rely solely on voluntary declaration of income by investors and on international exchange of information, if any. As regards the latter case, France and Finland do not require foreign investment funds to supply information concerning the income received by resident investors.[754] On the other hand, the United Kingdom and

[754] For France, see Blanluet – Portier, Investment Funds, 56. Finland has no special tax rules addressing foreign investment funds.

Germany impose obligations also on foreign investment funds. This is at least partly explained by their more extensive demand of information for tax purposes, due to the fact that both the states intend to tax income from investment funds yearly on a deemed distribution basis. To implement annual taxation, not only the tax authorities but also resident investors may need to be informed of the taxable income by foreign investment funds.

The United Kingdom. Foreign investment funds intending to be certified as distributing funds under the UK offshore funds legislation must provide the Internal Revenue with certain specified information as part of the certification process. The requested information includes audited accounts of the fund, together with a computation of the UK equivalent profits (UKEP), and of the amount and the date of any actual or projected distributions.[755] Obviously, such information may also be used for the purposes of taxation of UK investors, though the identification of the UK resident recipients of income cannot apparently be effected with the help of such information.

Germany. The requirements, with which foreign investment funds must comply, concerning the disclosure of taxable income for the purposes of German investors, correspond to those applicable to German investment funds.[756] Therefore, they are under obligation to notify investors of the amount and composition of the income taxable in the hands of underlying investors, and to publish such information in the German Official Gazette (*Bundesanzeiger).*

Apart from foreign investment funds, the information may be obtained from the payer of income, at the moment of a distribution to, or redemption of units by, the resident investor. Generally speaking, the payer of income may be either the investment fund, or, where appropriate, its management company, or a financial institution which acts as the paying agent through which distributions and other payments are made to investors. In a case where the payment is made through a paying agent established within the jurisdiction, the possibilities for national tax authorities to receive information on the income depend on the general reporting obligations imposed on domestic paying agents. However, in a case where the payment is not made through a paying agent established within the jurisdiction, possibilities of national tax authorities of obtaining the information on the income depend on not only the reporting obligations imposed on the payer of income in its state of establishment, but also on the effectiveness of information exchange between the tax authorities of the two states.[757]

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[755] See Smith – Turner, Investment Funds, 97.
[756] InvStG § 7(5).
[757] Juusela (2003) 28.

Finally, if the withholding tax which is levied on a distribution paid out by an investment fund to a non-resident investor is refundable under an applicable tax treaty, the tax authorities in the residence state of the latter may be indirectly notified of the foreign fund investment and the distribution thereon. This is because the investor generally needs a certificate of residence to apply for a refund in the source state. However, it is likely that this is of minor practical significance, because often the investor can accumulate the income in the fund rather than receiving a distribution, and can realize the income later as capital gains which are not subject to withholding tax. It is also possible that no withholding tax is levied, under national law, on the income paid out to non-resident investors. This is the case, for example, in Luxembourg, and in the United Kingdom in respect of a dividend distribution.

In the following sections, the possibilities for receiving information through international co-operation on the income from foreign investment funds by a resident investor will be examined. Firstly, the newly adopted directive on the taxation of savings income in the form of interest payments (Savings Tax Directive) is discussed. The aim is to examine to what extent the Savings Tax Directive will have impact on the tax enforcement of income derived from foreign investment funds. Secondly, possibilities of relying on the information exchange between national tax authorities of different states when enforcing the taxation of income from foreign investment funds are dealt with. The aim is to examine whether information exchange, as provided for by several international legal instruments, is effective when income from investment funds is involved.

6.3.2 Savings Tax Directive

General. The cornerstone of the Savings Tax Directive[758] is the principle of automatic information exchange between the tax authorities of Member States on cross-border interest payments. The provisions of the Savings Tax Directive should become applicable on 1 January 2005, provided that certain non-member states apply equivalent measures to those contained in the

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[758] Council Directive 2003/48/EC of 3 June on taxation of savings income in the form of interest payments, OJ L 157, 26/06/2003 p. 38-48. See also Proposal for a Council Directive to ensure effective taxation of savings income in the form of interest payments within the Community, COM (2001) 400 final. This proposal replaced the previous Proposal for a Council Directive to ensure a minimum of effective taxation of savings income in the form of interest payments within the Community, COM(1998) 295 final, submitted on 4 June 1998. The latter in turn replaced the Proposal for a Council Directive on a common system of withholding tax on interest income, COM(89) 60 final. For a presentation of the background to the Savings Tax Directive, see Mutén (2003) 309-314.

Directive.[759] The Savings Tax Directive is regarded as the most concrete international initiative for the purpose of improving the effectiveness of taxing international portfolio investments.[760] The ultimate aim is to ensure that savings income, in the form of interest payments paid from one Member State to individuals resident in another Member State, will be subject to effective taxation in the latter Member State.[761] The application is restricted to cross-border interest payments.[762] The Directive does not distinguish between the source of interest, and therefore, in principle, covers interest derived from debtors, irrespective of whether or not these are established within the Community. Rather its focus is on where the interest payment is made. Only payments made through paying agents established in Member States are covered by the Directive.[763]

The Savings Tax Directive will also affect the taxation of income from foreign investment funds, to the extent that the income falls within the scope of the Directive, and insofar as the paying agent, if not the fund itself, be not established in the same state as the investor. In the discussion below, the scope of the Savings Tax Directive with regard to income from investment funds is examined. Next, the systems of information exchange introduced by the Directive are presented, with the focus on fund investments.

Scope. The Savings Tax Directive applies to interest payments made from a Member State to a beneficial owner who is an individual resident in another Member State.[764] The beneficial owner is defined as "any individual who receives an interest payment or any individual for whom an interest payment is secured, unless he provides evidence that it was not received or secured for his own benefit".[765] Though the right interpretation of the notion 'secured for his own benefit' is generally subject to discussion[766], in the case of an individual fund investor it is safe to assume that he will be the beneficial owner of an interest payment for the purposes of the Directive.

From the perspective of investment funds and their investors, the crucial question is the definition of an interest payment within the meaning of the

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[759] The third countries include Switzerland, Liechtenstein, San Marino, Andorra and certain dependent or associated territories (the Channel Islands, the Isle of Man and the dependent or associated territories in the Caribbean). For details, see Art. 17(2)(i) and 17(2)(ii) of the Savings Tax Directive. Whether or not this is the case will ultimately be decided by the Council by unanimity. See Art. 17(3) of the Savings Tax Directive. There are some concerns as to whether all the third countries will satisfy the condition of applying equivalent measures. See Bell (2003) 211.
[760] See Juusela (2003) 33.
[761] Art. 1(1) of the Savings Tax Directive.
[762] In particular, the Savings Tax Directive leaves unaffected the Member States' domestic tax rules on taxing cross-border interest income.
[763] Explanatory Memorandum, Art. 1(2).
[764] Art. 1(1) of the Savings Tax Directive.
[765] Art. 2(1) of the Savings Tax Directive.
[766] For the interpretation of the notion, see Bell (2003) 203-205.

Savings Tax Directive. The qualification of an item of income as an interest payment in Article 6 of the Directive depends both on the nature of the underlying right (security) and on the circumstances in which an investor receives the income.[767] As for the nature of underlying rights, the definition encompasses debt-claims of every kind, largely following the definition of interest in Article 11(3) of the OECD Model Convention.[768] However, during a transitional period (up to and including 31 December 2010) certain debt-bearing instruments – referred to as 'negotiable debt securities' – are excluded from the definition of debt-claims, and consequently interest income from such grandfathered securities are not covered by the Directive.[769] As for the circumstances in which an investor receives income based on the above-mentioned rights, both actual payments of interest as well as any accrual or capitalisation of interest at a sale, refund or redemption are covered by the Directive.[770] In addition, and importantly, the Directive covers not only income, based on the above-mentioned rights, which is received directly by an investor but also the indirect receipt of income through an investment fund. In view of the latter case, the Directive distinguishes between the income deriving from interest payments by investment funds and the income realized on a sale, refund or redemption of units or shares in investment funds.[771]

In accordance with Article 6(1)(c) of the Directive, interest received in the form of a distribution by an investment fund as defined below will be covered by the Directive. Three types of investment fund are expressly mentioned: i) a UCITS authorised in accordance with the Directive 85/611/EEC, ii) certain entities which qualify for the option to be treated as UCITS under Article 4(3) of the Savings Tax Directive, and iii) undertakings for collective investment established outside the EU. Investment funds not authorised in accordance with the UCITS Directive are not covered by Article 6, unless they have elected to be treated as UCITS under Article 4(3) of the Savings Tax

[767] See Larking (2001) 226.

[768] According to Explanatory Memorandum, Art. 6, para. 1(a), the definition clearly encompasses cash deposits and securities in the form of money, and all types of corporate and government bonds, debentures and similar negotiable bonds.

[769] Art. 15(1) of the Savings Tax Directive. With respect to the types of security to be grandfathered, Art. 15 refers to 'domestic and international bonds and other negotiable debt securities'. According to the Explanatory Memorandum the term 'negotiable debt securities' includes "all types of debt security which may be traded freely on the secondary markets or which may be transferred by the holder of the security without the prior consent of the issuer". There are also further requirements for grandfathering in relation to the date of issuance of such securities. See for these Art. 15(1) of the Savings Tax Directive and Explanatory Memorandum, Art. 15(1); Bell (2003) 208; Larking (2001) 233.

[770] Art. 6(1)(a-b) of the Savings Tax Directive.

[771] Art. 6(1)(c-d) of the Savings Tax Directive.

Directive.[772] However, all undertakings for collective investment established outside the European Union are covered, irrespective of their legal form.[773]

The portion of income distributed by an investment fund which derives from interest payments to the fund is included within the scope of the Savings Tax Directive. According to the Explanatory Memorandum, the definition of an interest payment here is designed to be the same as in the case of a direct investment.[774] As a result, in regard to investment fund investments, the Savings Tax Directive aims to follow the principle of transparency.[775] In other words, the income which would be covered by the Directive had it been received directly by an investor, will also be covered by the Directive when received through an investment fund. Should this not be the case, the application of the Savings Tax Directive could be avoided in relation to investment funds, because a distribution could be classified as dividend under the law of a Member State.[776] While not clear from the text, the Directive also covers qualifying interest distributed by one investment fund to another.[777]

In certain cases, following the principle of transparency may turn out to be difficult. Such would be the case when a distribution contains not only qualifying interest income but also other items of income, such as dividends and capital gains not qualifying as interest. The correct identification of the interest portion in a distribution obviously requires the paying agent to have the necessary information concerning the composition of a distribution. If the paying agent does not have the necessary information, the total amount of a distribution will be deemed to constitute interest within the meaning of the Savings Tax Directive.[778] This makes it clear that the application of the Savings Tax Directive cannot be avoided by relying on insufficient information.

In addition to fund distributions, the Directive also covers the income realised on a sale, refund or redemption[779] of units or shares in investment

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[772] If such investment funds had not opted for treatment as UCITS, the interest income received through them would still not necessarily escape the application of the Savings Tax Directive. This follows from Art. 4(2) of the Savings Tax Directive which extends the definition of paying agent. An entity receiving interest is covered by the extended paying agent definition if it is established in a Member State, provided that it is not a legal person, not taxed on its profits under the general arrangements for business taxation and not a UCITS within the meaning of the UCITS Directive. Such an entity will be considered as a paying agent upon the receipt of the interest rather than upon the payment of the interest to a beneficial owner. See also Explanatory Memorandum, Art. 4(2). The responsibilities resulting from the qualification as a paying agent are dealt with later in this section.

[773] See Explanatory Memorandum, Art. 6(1)(c).

[774] Explanatory Memorandum, Art 6(1)(c).

[775] See Bernhard (2001) 666.

[776] See Brouwer – Kinnegim (2003) 11.

[777] This is stated in the Explanatory Memorandum, Art. 6(1)(c).

[778] Art. 6(2) of the Savings Tax Directive.

[779] In the following, only the case of a redemption will be referred to because it is in practice more common than a sale of units or shares to another investor or a refund.

funds which have invested more than 40 per cent of their assets in debt-claims.[780] As from 1 January 2011, this threshold will fall to 25 per cent.[781] Unlike in the case of fund distributions, no distinction is generally made between the underlying interest and non-interest portions of income, but the qualification as an interest payment within the meaning of the Directive depends only on the composition of the portfolio held by an investment fund. According to the Explanatory Memorandum this 'all-or-nothing' approach was designed to decrease the administrative burden of paying agents, resulting from the tracking-down of the origin of income.[782] However, the Member States have the option of following the principle of transparency in respect also of gains, with the consequence that only that part of the gain deriving from interest payments to the investment fund is included within the scope of the Savings Tax Directive.[783] Whether an investment fund meets the '40 per cent test' is to be determined primarily based on the fund's investment policy, as laid down in the fund rules or similar document.[784] Should there be no such document available, or if the proportion of debt-bearing instruments in the portfolio cannot be determined based on such a document, the actual composition of assets will be decisive.[785] In case there are more than one investment fund involved in the chain between an investor and a debt-claim, the '40 per cent test' will be applied at each fund level.[786] In the absence of relevant information, the total gain or proceeds realized on redemption of units or shares will be included in the definition of an interest payment.[787]

As regards the income realized on redemption of fund units or shares, Member States are also given the option of applying the Directive on a periodic basis, most likely annually, instead of deferring it to the moment of redemption, as under the general rule.[788] According to the Directive, the periodic application would mean that the paying agent annualises the interest over a certain period, and treats the annualised amount as an interest payment, even in the absence of a redemption during the application period (hereinafter 'annualisation method').[789] In line with the scope of the general rule, the annualisation method may take place only with respect to those

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[780] Art. 6(1)(c) of the Savings Tax Directive. Grandfathered 'negotiable debt securities' are not treated as debt-claims when determining the above percentages. See Explanatory Memorandum, Art. 15(1).
[781] Art. 6(7) of the Savings Tax Directive. According to the earlier proposal, the threshold were to be reduced to 15 per cent.
[782] Explanatory Memorandum, Art. 6(1)(d).
[783] Art. 6(1) of the Savings Tax Directive.
[784] Art. 6(8) of the Savings Tax Directive.
[785] Art. 6(8) of the Savings Tax Directive. See also Explanatory Memorandum, Art. 6(8).
[786] See Explanatory Memorandum, Art. 6(1)(d).
[787] Art. 6(3) of the Savings Tax Directive.
[788] Art. 6(5) of the Savings Tax Directive. The option applies also to the case of a direct investment (i.e. Art. 6(1)(b)). The period may not exceed one year.
[789] Art. 6(5) of the Savings Tax Directive.

investment funds which meet the '40 per cent test'. The annualisation of interest would apply to the whole non-distributed income generated by an investment fund (i.e. the increase in the unit or share price) over the annualisation period, this whole being treated as 'interest payment' for the purposes of the Directive.

Finally, Member States are provided with the possibility of excluding qualifying income from resident investment funds which have not invested more than 15 per cent of their portfolio in debt-claims as defined by the Directive.[790] According to the Explanatory Memorandum, this option aims to exclude from the scope of the Directive investment funds which invest predominantly in equity, but which also hold some debt for liquidity purposes.[791] The exemption of an investment fund from the Directive based on the '15 per cent test' may be based on the published investment policy or, where necessary, on actual composition of assets.[792] The exercise of the option by a Member State of residence of an investment fund is binding on other Member States, in that the latter cannot require paying agents established in their territory to provide information under the Savings Tax Directive.[793]

Automatic Exchange of Information. With respect to qualifying income, i.e. interest payments as defined, the Savings Tax Directive contains two-legged provisions concerning exchange of information. In the first place, the Directive imposes broad obligations on paying agents to provide information to the national tax authorities of their residence state. Secondly, the national tax authorities are obliged to communicate such information to the tax authorities of the respective residence states of beneficial owners. Both the minimum content and the mechanics of information exchange are prescribed in the Directive.

As regards the minimum content of information, the following details must be reported by the paying agent to the national tax authorities[794]:

1. The identity and residence of the beneficial owner;
2. The name and address of the paying agent;
3. The account number of the beneficial owner, or if none, identification of the debt-claim[795] giving rise to the interest;
4. Information concerning the interest payment.

The details to be reported in relation to the interest payment itself depend on the category of interest in question.[796] As regards distributions from

[790] Art. 6(6) of the Savings Tax Directive.
[791] Explanatory Memorandum, Art. 6(6).
[792] Art. 6(8) of the Savings Tax Directive.
[793] Art. 6(6) of the Savings Tax Directive. See also Explanatory Memorandum, Art. 6(6).
[794] Art. 8(1) of the Savings Tax Directive.
[795] In the case of investment funds, the 'debt-claim' must be understood as referring to fund units or shares held by an investor, and not to underlying securities held by an investment fund.

investment funds, either only the amount of interest in a distribution, or alternatively the full amount of a distribution is to be reported.[797] Based on the wording of the provision, it seems possible for paying agents to report exclusively the full amount of distribution, even in a case where the more detailed breakdown of a distribution into interest and other income, if any, would be available.[798] In this case, and insofar as the breakdown of a distribution into separate items of income is relevant for purposes of taxing a beneficial owner, such breakdown remains to be established in the residence state of the beneficial owner.[799]

As regards the income realized on a redemption of units or shares in funds investing more than 40 per cent of their portfolio in debt-claims, either the amount of income (ie. gain), or, alternatively, the full amount of proceeds paid to a beneficial owner must be reported.[800] The choice between these reporting alternatives is to be made by each Member State and it will bind the paying agents established in the Member State concerned.[801] As the reporting requirements do not cover the period of ownership or the purchase price of fund units or shares, the acquisition of such information, to the extent necessary for tax purposes, remains the responsibility of the tax authorities in the residence state of an individual investor. Finally, in a case where a Member State in which a paying agent is established has elected to apply the interest annualisation method, the amount of annualised interest must be reported.[802]

As regards the mechanics of information exchange between Member States, the Directive is based upon an automatic exchange of information. Whether particular information is superfluous, or whether additional information is required for the purposes of taxing an individual in the residence state, is irrelevant.[803] Information exchange must take place at least once a year, within 6 months following the end of tax year of the Member State in which the paying agent is established.[804] The refusal to exchange information on grounds stated in Article 8 of the Mutual Assistance Directive is expressly ruled out.[805] As becomes clear from the Explanatory Memorandum, the possibility given for Member States in the Mutual Assistance Directive to refuse exchanging

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[796] See Art. 8(2) of the Savings Tax Directive. For the details of the identification of beneficial owners to be made, see Bell (2003) 208-210.
[797] Art. 8(2)(c) of the Savings Tax Directive.
[798] See Larking (2001) 229.
[799] See Bernhard (2001) 666.
[800] Art. 8(2)(b) of the Savings Tax Directive.
[801] See Explanatory Memorandum, Art. 8(2)(b).
[802] Art. 8(2)(e) of the Savings Tax Directive.
[803] See Larking (2001) 229.
[804] Art. 9(2) of the Savings Tax Directive.
[805] Art. 9(3) of the Savings Tax Directive.

information based on the principle of reciprocity, in particular, could endanger the aim of the Directive.[806] Consequently, account has been taken of the obvious shortcomings of the Mutual Assistance Directive.[807]

By way of an exception, three of the Member States (Austria, Belgium, and Luxembourg) are not required to exchange information on interest payments made through paying agents established in their territory, for a transitional period as specified in the Directive. They are, however, entitled to receive information from other Member States for the purposes of taxing their own residents.[808]

Withholding Tax System. Instead of exchanging information, Austria, Belgium and Luxembourg are required to withhold a tax on interest payments made through a paying agent established in their territory. The rate of the withholding tax is set at 15 per cent for the first three years of the transitional period, 20 per cent for the subsequent three years and 35 per cent thereafter.[809] The revenue from the withholding tax to be levied by paying agents will be shared between the source state, which will retain 25 per cent of the tax, and the residence state of an investor, which will receive the rest of the tax.[810] Unlike in the earlier drafts, the transitional period lasts for an undetermined period of time[811], the ending of which is now subject to agreement between the Community and certain other countries including, Switzerland and the United States[812], providing for the exchange of information on request as defined in the OECD Model Agreement on Exchange of Information on Tax Matters. Doubts have been, however, expressed as to whether the transitional period will not turn out to be permanent rather than of a temporary nature, in view of the fact that Switzerland has signaled its refusal to accede to the agreement.[813]

The definition of an interest payment and a debt-claim for the purposes of the Directive is the same, irrespective of whether an information exchange or a withholding tax procedure is applied. Consequently, interest payments based on directly held debt-claims and on distributions by non-excluded ('15 per cent test') investment funds – to the extent they include qualifying interest income – will undergo withholding tax.[814] Unlike in the case of information exchange, the Directive does not expressly provide for the possibility to withhold tax on the whole amount of a fund distribution, and thereby the

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[806] See Explanatory Memorandum, Art. 9(3).
[807] See for these, Chapter 6.3.3.
[808] Art. 10 of the Savings Tax Directive.
[809] Art. 11(1) of Savings Tax Directive.
[810] Art. 12(1) of the Savings Tax Directive.
[811] Instead of the seven years which was the earlier proposal.
[812] In addition, Liechtenstein, San Marino, Monaco and Andorra.
[813] See Gray – Hildrey (2003) 17.
[814] Art. (11)(2a) and (11)(2c) of the Savings Tax Directive.

inclusion of possible other items of income in the tax base is, in principle, not permitted. However, in the absence of a necessary identification of the interest element in a distribution, a paying agent would practically be compelled to withhold tax on the whole distribution, in order to be able to comply with the Directive.[815]

As regards interest income realized on redemption of fund units or shares, the withholding tax is to be levied pro rata to the period of holding of the fund units[816] by the beneficial holder.[817] By this method, only the amount of interest attributable to the holding period of the beneficial owner would undergo withholding tax.[818] Unfortunately, neither the Directive nor the Explanatory Memorandum deals with the practical application of this pro rata approach by paying agents. Here reference might be made to the pre 2004 German taxation of interim profits, which followed essentially the pro rata approach as laid down in the Directive. It seems likely that each fund falling within the scope of the Directive should calculate on a daily basis the amount of qualifying interest income earned by the fund. The taxable amount would then be determined by deducting the interest income, at the moment of acquisition of fund units, from the amount capitalised in the fund at the moment of a disposal by the concerned investor. However, another matter left open in the Directive is the treatment of capitalised income prior to the date of coming into force of the Directive.[819]

The paying agent does not have to apply the pro rata approach in a case where it is unable to determine the period of ownership by the beneficial owner on the basis of available information.[820] In such a case, the whole amount of capitalised interest income would be subject to withholding tax, irrespective of holding period. This might lead to a very disadvantageous treatment of investors, in that the amount of withheld tax would be likely to exceed substantially the final tax burden in the residence state. Although any excessive tax would be refundable in the investor's residence state, there would be a significant disadvantage from a cash-flow point of view.

In contrast to fund distributions, the Directive also provides Member States for an alternative method of levying 'a tax of equivalent effect' on the full amount of the proceeds of a redemption.[821] The choice between the two

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815 See Larking (2001) 232.
816 Specifically, the text refers to the 'debt-claim' but as already mentioned in an investment through an investment fund this must be understood as 'fund unit' or 'fund share'.
817 Art. (11)(2)(b) of the Savings Tax Directive.
818 See Explanatory Memorandum, Art. 11(3).
819 Larking (2001) 232.
820 Art. 11(3) of the Savings Tax Directive.
821 Art. 11(2)(b) of the Savings Tax Directive. The reason for this alternative method is the Belgian wish to continue applying its current financial transaction tax. See Larking (2001) 232.

alternative methods is to be made by each Member State. The condition for levying such a tax is that it does not lead to a lower tax burden on the interest income by the beneficial owner in the state of the paying agent.[822]

In line with the Directive's ultimate objective of ensuring the effective taxation of interest income in the investor's residence state, the state of the paying agent must provide investors with the possibility of avoiding the imposition of a withholding tax on request.[823] For this purpose, the Directive lays down two procedures, of which at least one must be applied by a Member State.[824] The first is based on voluntary information exchange, whereby the beneficial owner of the interest authorises the paying agent to report information concerning the income, in accordance with the information exchange provisions of the Directive. The authorisation will cover all interest income paid to the beneficial owner by the paying agent.[825] The second procedure is based on certification on the side of the investor's residence state. The purpose of certification is to make the tax authorities in the residence state aware of certain tax relevant information as specified by the Directive.[826]

Finally, the Directive lays down provisions aimed at eliminating double taxation of interest income.[827] As a general rule, a credit must be given by the investor's Member State for the tax withheld on interest in accordance with the Directive.[828] A credit must be given up to the the level of the tax due on such income in the investor's residence state. Should the withheld tax exceed the tax due in the residence state, any excess tax must be repaid to the investor by the state of residence. Otherwise, the details of elimination procedure are left to be handled under the domestic laws of the Member States.[829] As an alternative, a Member State may replace the tax credit mechanism by simply refunding the withholding tax levied by a paying agent in another Member State.[830]

Besides the general rule, the Directive deals with the situation where interest income is subject to another withholding tax, in addition to a tax to be levied under the Directive. The Explanatory Memorandum refers specifically to 'debtor-type withholding taxes' levied in a Member State other than that of

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[822] Explanatory Memorandum, Art. 11(2)(b).
[823] See Explanatory Memorandum, Art. 13(1).
[824] Art. 13(1) of the Savings Tax Directive.
[825] Art. 13(1)(a) of the Savings Tax Directive.
[826] According to Art. 13(2) of the Savings Tax Directive, the certificate must include information regarding the beneficial owner (the name, address and tax or other identification number, or if not available, the date and place of birth), the paying agent (the name and address) and the account number of the beneficial owner, or if not available, the identification of the security.
[827] Art. 14 of the Savings Tax Directive.
[828] Art. 14(1) of the Savings Tax Directive.
[829] Art. 14(2) of the Savings Tax Directive.
[830] Art. 14(3) of the Savings Tax Directive.

the paying agent, or in a third country. The Explanatory Memorandum uses, as an example, a situation where a withholding tax is first levied in a state where a debt-claim is issued, followed by a tax levied by the paying agent in another state in accordance with the Directive.[831] In the context of investment fund investments, a corresponding double withholding tax situation – as referred to in the Explanatory Memorandum – would occur in a situation where there are three different countries involved, ie. the residence state of the investment fund, the establishment state of the paying agent and the investor's residence state. Should the investment fund impose a withholding tax on the (interest) distribution under the domestic law and the paying agent under the Directive, the (interest) distribution would undergo a withholding tax twice. However, in theory, double withholding taxation could also occur when the investment fund and the paying agent are resident in the same Member State, and where both are liable to withhold a tax on interest under domestic law and the Directive, respectively.[832]

At any rate, in case the interest income received by the investor has also been subject to any other type of a withholding tax than that levied under the Directive, the residence state must first give a credit for such other withholding tax. The prerequisite for this treatment is that the withholding tax would be creditable under either domestic law or a tax treaty.[833] The priority given to other withholding taxes is in order to make sure that any excess tax resulting from the levy of two withholding taxes will be refunded to the maximum in the investor's residence state. The necessity to give the priority to other withholding taxes results from the fact that only the withholding tax under the Directive would entitle the investor to a refund, since this is expressly required by the Directive, whereas the other withholding taxes typically cannot be refunded under domestic tax laws.[834]

In the context of investment fund investments, double withholding taxation of interest income would also occur in a case where interest income distributed

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[831] See Explanatory Memorandum, Art. 14(3).

[832] The Directive does not expressly prohibit Member States from imposing another withholding tax than that under the Directive.

[833] Art. 14(3) of the Savings Tax Directive.

[834] The importance of the order of crediting taxes may be considered by using as an example a situation where Member State A levies a debtor-type withholding tax of 15 per cent on the interest, Member State B levies a withholding tax of 20 per cent on the interest under the Directive, and finally in Member State of residence C the interest is subject to tax of 25 per cent. Given the priority of the other withholding tax, Member State C must first credit 15 per cent for the tax levied in Member State A, with a residual tax burden of 10 per cent. Subsequently, a tax credit of 10 per cent for the withholding tax under the Directive must be given and the rest of the tax must be refunded to the investor. If the withholding tax under the Directive had been credited first, there would be a residual tax burden of 5 per cent in Member State C. The withholding tax levied in Member State A would then be creditable to the remaining tax burden of 5 per cent. However, in the end there would still remain a tax of 10 per cent which would not be refundable.

to the investor had already been subject to tax in the source state of income, when paid to an investment fund. This sort of double taxation differs from the example of ’debtor-type withholding taxes’ in that it is more of an economic nature, i.e. the same income rather than the same taxpayer is subject to double taxation. The question arises whether the priority given to crediting other withholding taxes is also applicable in this case.

The wording used in the Directive refers to “interest received by a beneficial owner”. Some Member States, particularly those not following strictly the transparency principle, could claim that the interest received by a beneficial owner, in the form of a fund distribution, is different from the interest originally received by the investment fund (’transformation of income’). However, it is arguable that, for the purposes of applying the Directive, the position based on transformation of income at the fund level cannot generally be upheld, as this could water down the Directive’s aim, namely of covering, not only directly but also through investment funds received, interest income. In any case, this difference in argumentation is insignificant, bearing in mind that the Directive requires other withholding taxes to be credited first only if a tax credit for such taxes is granted, under domestic law or tax treaties. Consequently, whether a withholding tax, levied at source on interest paid to the investment fund, is credited against the underlying investor’s tax liability in the residence state will ultimately remain dependent on domestic tax law and tax treaties.[835] Should the withholding tax be creditable, such a tax should, under the Directive, be credited prior to a tax withheld under the Directive, and excess tax being repaid to the investor.

6.3.3 International Exchange of Tax Information

General. Where no domestic parties other than an investor are involved, the information, if any, supplied by a resident investor, in respect of income from a cross-border fund investment, can be effectively verified by the residence state only if the following two conditions are being satisfied. First, the information must be in the possession of, or available to, the tax authorities in the residence state of the foreign investment fund. Second, the information must be automatically transmitted, or at least provided on request, to the tax authorities of the first-mentioned state. As explained in the previous section of the study, the Savings Tax Directive does meet both the conditions. Nonetheless, its impact is limited to income qualifying as interest payment within the meaning of the Directive, whereas other types of income are not

[835] Similarly, Larking (2001) 231.

covered. Even a certain part of income which in principle is covered by the Savings Tax Directive is excluded from the scope of the measures by the 40 per cent and 15 per cent tests. As a result of this, there seems to remain the need for national tax authorities to rely on traditional legal instruments, with regard to the mutual exchange of tax information. In the following, the availability of information for the tax authorities in the residence state of the investment fund is first examined in the selected Member States, and subsequently, the legal bases, forms and limitations of international exchange of tax information between tax authorities are discussed.

Availability of information. As regards the availability of information in the state of the investment fund, it seems that in the case of Luxembourg investment funds this poses serious difficulties. As Luxembourg investment funds are not required to provide automatically any information which is relevant for the purposes of taxing investors, such information cannot be transmitted to the tax authorities of other states. Furthermore, Luxembourg tax authorities may rely on the comprehensive bank secrecy in Luxembourg, which also covers investment funds and other related parties, as a ground for refusing to exchange information with the other Member States.[836]

As for German investment funds, they must notify underlying investors of the taxable income earned over an accounting period, and must also supply the German tax authorities with such information. However, the information is used for the purposes of determining the taxable income in the hands of German investors, and does not disclose, for example, the identities of underlying investors. It is not, therefore, of use as such for foreign tax authorities.

The same seems to apply to UK investment funds, which are obliged to file a tax return for their own tax purposes and to notify underlying investors of certain tax relevant information. It must also be noted that, in Germany generally, and in the United Kingdom with some exceptions, neither banks nor, it is assumed, investment funds, are required to report automatically information concerning distributions and redemption of units to tax authorities.[837] Hence, the information needed for the purposes of taxing non-resident investors in their residence states would not readily be available to the national tax authorities.

On the other hand, in the case of Finland and France, national tax authorities are likely to be in possession of relevant information with respect to investors of domestic investment funds, on account of efficient national tax control.

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[836] See Terra – Wattel (2001) 470.
[837] See OECD (2000) 72-73.

Information exchange. Within the European Union, there are several overlapping legal instruments providing for exchange of information between the tax authorities of different Member States, of which the most important ones are bilateral tax treaties between Member States and the Mutual Assistace Directive.[838] In the first place, most tax treaties include a provision concerning the exchange of information between contracting states. Such a provision is usually adopted on the basis of Article 26 of the OECD Model Convention[839], under which information necessary for the correct application of tax treaty provisions, or for the implementation of national tax laws, should be exchanged between contracting countries. It is noteworthy that the duty to exchange information is not restricted to information which is necessary[840] for the application of tax treaty provisions, but extends to information required for the application of national tax laws ('broad exchange of information clause')[841]. This also underpins the role of tax treaties as a means of preventing tax avoidance and evasion.[842] Nevertheless, the exchange of information is limited to cases where the type of tax in question is covered by

[838] In addition to bilateral tax treaties and the Mutual Assistance Directive, there are two other multilateral conventions under which exchange of information between tax authorities may be invoked. First, for the relationships between tax authorities of the Nordic countries, there is the Nordic Convention on Mutual Assistance in Tax Matters. As Finland is the only Nordic country covered by this study, the Nordic Convention on Mutual Assistance will not be dealt with here. However, it may be noted that the Nordic Convention on Mutual Assistance provides by far the most far-going forms of mutual assistance among the legal means of administrative assistance, and that it has also in practice turned out to be a rather efficient means. See Juusela (1998) 279-281; Wisselink (1997) 111. Generally, mutual assistance between tax authorities of neighboring countries tends to be more efficient than on average. See Spatscheck – Alvermann (2001) 37. Another multilateral convention concerning mutual administrative assistance in tax matters was jointly drafted by the Council of Europe and the OECD (the Multilateral Convention on Mutual Administrative Assistance on Tax Matters). However, of the countries covered by this study, only Finland has ratified it. For the Convention, see Wisselink (1997) 112-113.

[839] In 2002, the OECD released the Agreement on Exchange of Information on Tax Matters, which is intended to represent a new model for effective information exchange. However, this agreement covers only exchange of information on request but not, for example, automatic exchange, which is of most interest for the purposes of this study. See Art. 5 of the Agreement on Exchange of Information on Tax Matters and Art. 5 para. 39 of the Commentary thereon. For that reason, and because, for the time being, the existing tax treaties are based on Art. 26 of the OECD Model Commentary, the Agreement on Exchange of Information on Tax Matters will not be dealt with in this study. It is also expected that the new agreement will be most relevant in relationships involving tax havens. See Végh (2002) 399. For further discussion on the agreement, see Oberson (2003) and Barnard (2003).

[840] In some tax treaties, the wording "necessary" is replaced with "relevant", which can be regarded as referring to a somewhat broader exchange of information between contracting states. See Ar. 26 para. 5 of the OECD Model Commentary. For example, Finland has adopted the wording "relevant" in eight bilateral tax treaties. See Juusela (1998) 279.

[841] In contrast, a so-called narrow exchange of information clause refers to a provision which restricts the duty to exchange information to situations dealing with the correct application of the tax treaty. Vogel et al. (1997) 1409-1410, use the terms 'major information clause' and 'minor information clause' respectively. Of the developed countries, only Switzerland insists on inserting a narrow exchange of information clause in its tax treaties.

[842] See OECD (1994b) para. 19; Tanzi – Zee (2000) 322.

the tax treaty, and where the taxation under domestic tax laws is not contrary to the tax treaty.[843]

In addition to tax treaties, there is the Council Directive 77/799/EEC, concerning mutual assistance by the competent authorities of the Member States of the European Union in the field of direct taxation (The Mutual Assistance Directive)[844], as implemented into the national legislations of the Member States. Under Article 1 of the Mutual Assistance Directive, the Member States must exchange any information that may enable them to effect a correct assessment of taxes on income and on capital.[845] The wording "may enable" has been interpreted to mean that the threshold of the application of the Mutual Assistance Directive would be lower than that of Article 26 of the OECD Model Convention (cf. "is necessary").[846]

As a result, within the EU, there is likely to occur overlap between various legal bases upon which exchange of information between tax authorities may be invoked. Practically, the most important issue is the relationship between the Mutual Assistance Directive and the exchange of information articles of bilateral tax treaties concluded between the Member States[847]. The possible collision with other legal instruments is addressed in Article 11 of the Mutual Assistance Directive, which essentially provides that, in the case of overlapping provisions, the most effective ('wider-ranging') instrument is to prevail.[848] Therefore, if a tax treaty provides for wider-ranging possibilities for the exchange of information, it – rather than the Mutual Assistance Directive – will be applied.[849] In such a case, the Member States are nevertheless bound by the principles of the Mutual Assistance Directive, which in effect continues to prevail with regard to the details of the information exchange.[850] In practice, it is common for the Member States to refer both to the Mutual Assistance Directive and to the relevant tax treaty when exchanging information.[851]

International exchange of tax information may take several different forms. The OECD Model Convention does not refer to any particular form, but the OECD Model Commentary deals with a variety of forms in which information exchange may take place. The Mutual Assistance Directive, in turn, is more

[843] Art. 26(1) para. 5 of the OECD Model Commentary.
[844] OJ L 336, 27/12/1977 p. 15-20.
[845] The taxes covered by the Mutual Assistance Directive are further elaborated in its Art. 1(2)-(3).
[846] See Juusela (1998) 284, footnote 70.
[847] In the case of Finland, it should be added, also the Nordic Convention on Mutual Assistance in Tax Matters.
[848] See also OECD (1994b) para. 12.
[849] Vogel et al. (1997) 1418.
[850] OECD (2000) 30. For the relationship of the Mutual Assistance Directive and tax treaties, see Terra – Wattel (2001) 474-475.
[851] OECD (1994b) para. 91. According to Vogel et al. (1997) 1418-1419, Member States hardly ever use the Mutual Assistance Directive, but rather the relevant tax treaty, as a means of information exchange.

elaborate in this respect and specifies the forms of information exchange. Both the OECD Model Commentary and the Mutual Assistance Directive refer to three different ways in which information may be exchanged between tax authorities, these being automatic exchange[852], spontaneous exchange[853] and exchange on request[854]. In the following, each method of information exchange will be discussed in greater detail, particularly in view of the significance for the effective tax control of cross-border fund investments. Finally, the limitations on international exchange of tax information will be discussed.

Automatic exchange of information. Automatic exchange of information refers to a situation where a contracting state systematically transmits tax information to the other contracting state.[855] Unlike in the other forms of information exchange, information supplied does not relate to a particular tax case, but is rather of general character. Automatically transmitted information should typically be cover many similar cases, and should be already available under the contracting state's own national tax control system, both factors being essential in making a routine basis transmission of information possible.[856] Basically, automatic exchange seems therefore to be suitable for the purposes of automatically exchanging information in respect of cross-border portfolio investments between tax authorities. However, in practice, neither the OECD Model Convention and its Commentary nor the Mutual Assistance Directive specifies the conditions as to when and how automatic exchange should take place.[857] At the moment, there seem also to be no comprehensive schemes for automatic exchange of information, in respect of portfolio investments effected under the referred conventions between the Member States.[858]

Spontaneous exchange of information. Spontaneous exchange of information refers to a method whereby a contracting state sends information to the other contracting state without the latter's prior request. Information exchanged spontaneously will often be of a more specific nature than that automatically exchanged. On the other hand, the number of taxpayers to

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[852] See Art. 26 para. 9(b) of the OECD Model Commentary and Art. 3 of the Mutual Assistance Directive.
[853] See Art. 26 para. 9(c) of the OECD Model Commentary and Art. 4 of the Mutual Assistance Directive.
[854] See Art. 26 para. 9(a) of the OECD Model Commentary and Art. 2 of the Mutual Assistance Directive.
[855] See Art. 26 para. 9(b) of the OECD Model Commentary.
[856] See OECD (1994b) para. 79; Juusela (1998) 288-291.
[857] Art. 3 of the Mutual Assistance Directive expressly leaves this to be determined by the competent authorities of Member States. However, the Nordic Convention on Mutual Assistance in Tax Matters in its Art. 11 is more specific in this respect. See Juusela (1998) 289-290.
[858] See Tanzi – Zee (2000) 329, footnote 9.

whom the supplied information relates is likely to be far smaller than in the case of automatic exchange. Neither the OECD Model Convention nor its Commentary further elaborates the situations where spontaneous exchange of information might be invoked. However, the Mutual Assistance Directive provides expressly situations in which information must be forwarded to other Member States:

> "a) The competent authority of the one Member State has grounds for supposing that there may be a loss of tax in the other Member State;
> b) A person liable to tax obtains a reduction in or an exemption from tax in the one Member State which would give rise to an increase in tax or to liability to tax in the other Member State;
> c) Business dealings between a person liable to tax in a Member State and a person liable to tax in another Member State are conducted through one or more countries in such a way that a saving in tax may result in one or the other Member State or in both;
> d) The competent authority of a Member State has grounds for supposing that a saving of tax may result from artificial transfers of profits within groups of enterprises;
> e) Information forwarded to the one Member State by the competent authority of the other Member State has enabled information to be obtained which may be relevant in assessing liability to tax in the latter Member State."

As the provision concerning the spontaneous exchange is very general in its nature and subject to interpretation, its practical importance will in the end depend on whether tax authorities of a Member State possess any relevant information, and on their willingness to co-operate with the authorities of other states.[859]

Exchange of information on request. Exchange of information on request may be relied on when the requesting tax authorities by themselves are incapable of obtaining the necessary information for taxation purposes. The requested information must always relate to a particular case. In addition, all regular sources of information available under the internal taxation procedure of the requesting authorities must have been exhausted before asking for assistance from the tax authorities of the other state ('the exhaustion rule').[860] However, in contrast to the above-mentioned forms of information exchange, the tax authorities of the requested country do not necessarily have the desired information available prior to the request. In such a case, the Mutual

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[859] See OECD (1994b) para. 80; Juusela (1998) 291-293.
[860] See Art. 2(1) of the Mutual Assistance Directive and Art. 26 para. 9(2) of the OECD Model Commentary. The exhaustion rule essentially expresses the principle that administrative assistance is always secondary to national measures. See for this, Juusela (1998) 300-303.

Assistance Directive expressly provides that the requested authorities must take necessary measures to obtain the requested information.[861] The OECD Model Commentary embodies an essentially similar obligation with respect to Article 26 of the OECD Model Convention.[862]

Limitations on information exchange. The exchange of information clause in tax treaties and the Mutual Assistance Directive subject the obligation to provide, or the right to receive, information to numerous limitations. In principle, the requested authorities have wide discretionary powers either to supply or to refuse to supply the information requested.[863] However, in the case of refusal, the requested country must rely on one of the grounds laid down in the relevant tax treaty or the Mutual Assistance Directive. The grounds for refusal are essentially the same under the OECD Model Convention (Article 26(2)) and the Mutual Assistance Directive (Article 8).

The requested country is not obliged to supply the information which is not obtainable under its laws or administrative practices[864] or to take measures which are prevented by the laws or administrative practices.[865] Therefore, the requested country is not bound to go beyond its internal laws or administrative practices, in order to acquire the information asked for by the requesting state within the framework of international co-operation.[866] In view of the tax control of cross-border portfolio investments, the most important limitation arises from bank secrecy rules governing the financial services sector, which in some jurisdictions considerably restrict the possibilities of tax authorities of obtaining information for tax purposes from financial institutions. A jurisdiction with strict bank secrecy has no obligation to supply the requested information if this is prevented by bank secrecy. Within the European Union, the recognition of sovereignty in the field of tax control means also that the

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[861] See Art. 2 of the Mutual Assistance Directive.

[862] See Art. 26 para. 16 of the OECD Model Commentary.

[863] As regards the OECD Model Convention, see Wisselink (1997) 110; OECD (1994b) para. 44. The same would seem to apply to the Mutual Assistance Directive. In accordance with Art. 5 of the Mutual Assistance Directive, the requested Member State must state the nature of the obstacle to or the reasons for the refusal to supply the requested information.

[864] The term administrative practice is understood to cover, among others, methods of interpretation of tax laws, code of conduct for tax authorities and customary rules. See Wisselink (1997) 110.

[865] See Art. 26(2)(a-b) of the OECD Model Convention and Art. 8(1) of the Mutual Assistance Directive.

[866] This limitation reflects the sovereignty of countries in the field of tax control. This means that countries are not only free to choose the methods and scope of their national tax controls, but also are not obliged to deviate from the national principles for the benefit of other countries, under international obligations. Furthermore, the equation of administrative practices with laws implies that the intention is to secure the factual sovereignty of countries in matters of tax control. See Juusela (1998) 303-308.

Member States are allowed to practice tax competition by means of an ineffective tax control.[867]

The international exchange of tax information is also restricted by the principle of reciprocity. The principle of reciprocity is expressed in both the OECD Model Convention and the Mutual Assistance Directive, though in different wording.[868]

> Under Article 26(2) of the OECD Model Convention "[the requested state is not obliged]: a) to carry out administrative measures at variance with the laws and administrative practices of that or of the other Contracting State; b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State."
> The same is expressed in Article 8(3) of the Mutual Assistance Directive: "The competent authority of a Member State may refuse to provide information where the State concerned is unable, for practical or legal reasons, to provide similar information."

Essentially, the principle of reciprocity means that the requested country is not obliged to provide assistance in excess of that which it can expect to receive in return from the requesting country. As regards reciprocity, a distinction may be made between legal reciprocity and factual reciprocity.[869] Legal reciprocity refers to the possibilities, of both the requesting and the requested state, of obtaining the requested information, whether by law or administrative practice. It follows from legal reciprocity, that there is an obligation to provide information only insofar as the information is obtainable for the tax authorities of both the states.[870] Factual reciprocity, in turn, refers to the actual or expected balance in the amount of information actually exchanged, as well as sacrifices made therefore between the requested and requesting state.[871] The assessment of whether the condition of reciprocity is fulfilled is largely in the hands of the requested country. In practice, the principle of reciprocity is of little significance in the field of international administrative assistance.[872] This is because the countries mainly interested in

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[867] Juusela (1998) 305. The Commission has proposed an amendment to the Mutual Assistance Directive which would abolish the possibility of relying on bank secrecy based on administrative practice rather than law, when declining a request for information from another Member State. See Terra – Wattel (2001) 470.

[868] See Art. 26 (2)(a-b) of the OECD Model Convention and Art. 8(3) of the Mutual Assistance Directive.

[869] OECD (1994b) para. 45.

[870] According to Art. 26(2) para. 15 of the OECD Model Commentary, the limitation is aimed at preventing the other contracting state from taking advantage of the information system of the other state if it is wider than its own system. See also OECD (1994b) para. 47-48; Vogel et al. (1997) 1440-1441.

[871] See OECD (1994b) para. 46; Juusela (1998) 315-317.

[872] See Juusela (1998) 317.

acquiring information by means of exchange of information typically are countries with an effective national tax control. Consequently, there often is little ground for the requested country to refuse to provide information by reference to reciprocity whether legal or factual.

Finally, the requested country has the right to refuse to provide information which would lead to the disclosure of certain business, professional or similar secrets.[873] However, in view of the kind of information related to portfolio investments, the limitation is hardly of significance.[874]

As regards the exchange of information between Member States, it may be noted that automatic exchange, on the basis of bilateral tax treaties and the Mutual Assistance Directive, has so far been insignificant, though there are some minor exceptions[875]. Therefore, in the case of non-compliance, it is highly unlikely that the tax authorities in the investor's residence state would receive sufficient information on an automatic basis, to enable their efficient taxation in respect of cross-border investment fund investments.[876] On the other hand, spontaneous exchange of information, or exchange on request, are generally insufficient to guarantee an effective verification of information and comprehensive taxation of cross-border investors, on account of the great number of portfolio investors.[877]

6.4 Conclusions

This chapter has demonstrated that there generally are significant differences in a Member State's capacity to enforce taxation effectively between investments in domestic and foreign investment funds. In the former case, the information provided by the fund investor may, as a rule, be effectively verified through information acquired from third parties by a Member State imposing tax reporting obligations. In the latter case, however, the tax authorities usually must rely solely on voluntary declaration of income by the

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[873] See Art. 26(2)(c) of the OECD Model Convention and Art. 8(2) of the Mutual Assistance Directive.

[874] According to OECD (2000) 88-89, most states do not regard bank information as constituting 'secrets'. In addition, under the OECD Model Convention and the Mutual Assistance Directive, the requested country may refuse to provide information, the disclosure of which would be contrary to public policy (ordre public). In practice, it has been invoked only rarely. See Juusela (1998) 314.

[875] For example, based on Art. 11(1)(1) of the Nordic Convention on Mutual Assistance in Tax Matters, Sweden transmits automatically information concerning cross-border interest payments and bank accounts to Finnish tax authorities. See Juusela (1998) 348 ff. Based on Art. 11(1)(a) of the Nordic Convention on Mutual Assistance in Tax Matters, it seems that also distributions by investment funds are covered by the obligation to exchange information automatically between the Nordic Countries.

[876] See Tanzi – Zee (2000) 329, in regard to portfolio investments generally.

[877] See Tanzi – Zee (2000) 329, who refer also to the source state's difficulties in identifying non-resident investors as another obstacle to effective information exchange.

fund investor. The information, if any, provided by the investor cannot typically be effectively verified by tax authorities of the investor's residence state, owing to the lack of information exchange between the tax authorities of the Member States, or simply because the tax authorities in the residence state of an investment fund do not have the necessary information.

It was also concluded that only an automatic information exchange between tax authorities of the Member States, with respect to income and capital gains received based on cross-border fund investments, would level the differences in the efficiency of tax enforcement, as compared to domestic fund investments. Other forms of information exchange would generally fail to ensure an effective taxation of income from cross-border fund investments. However, despite the various legal instruments, there are no comprehensive schemes of automatic information exchange between Member States, covering income from cross-border fund investments. However, as of 2005, the Savings Tax Directive will bring part of cross-border fund investments within the scope of automatic information exchange. Nonetheless, a significant proportion of income from cross-border fund investments will remain outside the scope of the Savings Tax Directive.

The differences in the efficiency of tax enforcement, with respect to investment fund investments also, have important repercussions when considering the treatment of investment fund investments from the perspective of tax neutrality within the single market. In this regard, the adoption of the Savings Tax Directive, which is primarily based on an automatic information exchange between tax authorities of the Member States, is an important step. Despite there being several restrictions as to its applicability to investment fund investments, it provides a useful starting point for the examination of the possibilities of a more comprehensive tax control between Member States with respect to cross-border investment fund investments. In Chapter 8 of the study, the impact of the Savings Tax Directive on the aim of establishing a single market for investment funds will be discussed, and the possibilities of introducing more comprehensive tax measures, along the lines of the Savings Tax Directive, is examined.

7 TAXATION OF INVESTMENT FUND INVESTMENTS AND NEGATIVE INTEGRATION

7.1 Introduction

The purpose of this chapter is to explore the impact of negative integration on the tax treatment of investment funds and their investors.[878] Negative integration may be defined as integration through legally enforceable prohibitions on certain measures of Member States which violate the basis of an internal market[879] or a single market[880].[881] The single market comprises an area without internal frontiers in which the free movement of goods, persons, services and capital are ensured ('fundamental freedoms').[882] The EC Treaty puts the aim of an internal market into effect by guaranteeing the free movement of goods[883], persons[884], capital[885], and freedom to provide services[886] under specific provisions. The four fundamental freedoms encompass two principles which essentially aim at the creation of an internal market: a right of cross-border circulation (market access) and a prohibition of

[878] The Community activity through which the internal market is to be attained may be broadly categorized as positive integration and negative integration. Positive integration refers to measures requiring prior decision-making by the Community organs. The impact of positive integration on the tax treatment of investment fund investments will be explored in the following chapter of the study.
[879] In the EEC Treaty the term common market instead of internal market was used. It comprised not only the four freedoms as defined in the forthcoming discussion, but also various other policy areas such as agricultural policy, competition policy and policy in respect of state aids. Despite the introduction of the term internal market in the EC Treaty, the term common market was nevertheless also retained in the EC Treaty. See Mortelmans (1998) 107. The establishment of the internal market is sometimes described as a short-term objective which serves to fulfill the long-term objectives of the Union as defined in Art. 2 EC. See Joutsamo et al. (2000) 18-20.
[880] Terminology is not settled. The term internal market is used in the EC Treaty, whereas in several Community documents the term single market is used instead. The two terms have been considered to be synonymous. It has been remarked that the European Court of Justice (ECJ), too, uses the two terms without distinguishing as between them. See Mortelmans (1998) 107.
[881] Terra – Wattel (2001) 22.
[882] See Art. 14 EC. The background idea of establishing an internal market by combining the national markets of several Member States is to improve productivity and enhance economic growth within the European Union. See Joutsamo et al. (2000) 405-406.
[883] Art. 25 and 28 EC.
[884] Art. 39 and 43 EC. The free movement of persons is described in the EC Treaty, in respect of employees, 'freedom of movement for workers' whereas in respect of undertakings and self-employed persons it is called 'right of establishment'.
[885] Art. 56 EC.
[886] Art. 49 EC.

discrimination on grounds of nationality or origin (market equality).[887] The fundamental freedoms therefore guarantee a constitutional minimum of economic integration within the Community[888], irrespective of whether any positive integration is achieved at the Community level. However, the fundamental freedoms are not absolute. An overriding reason of public interest can justify a national measure that otherwise would risk being incompatible with Community law.

The EC Treaty can affect national tax rules and practices to the extent that treaty provisions have direct effect, and because Community law prevails over incompatible national law.[889] Importantly, each of the fundamental freedom provisions has been recognized by the ECJ as having direct effect.[890] A provision having direct effect grants citizens rights which must be upheld and protected by the national courts.[891] In accordance with the principle of supremacy of Community law, a directly effective provision of Community law always prevails over an incompatible provision of national law.[892] If a national tax measure is found incompatible with Community law, a Member State is prohibited from applying such a measure, and is obliged to abolish or change it.[893] EC Treaty provisions having direct effect, such as the fundamental freedoms, are directly applicable law in the legal systems of the Member States.[894]

Although most of integration achieved in the field of direct taxation is a result of negative integration[895], there is, for the time being, no case law on the taxation of investment funds and their investors. However, this does not imply that Community law has not had any impact on existing tax regimes governing

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[887] Terra – Wattel (2001) 30.

[888] Van Thiel (2001) 4. It can also be said that fundamental freedom provisions serve as a minimum guarantee for market openness between Member States. See Wouters (1999) 101.

[889] Terra – Wattel (2001) 29.

[890] The direct effect of certain EC Treaty provisions was established by the ECJ in *Van Gend en Loos,* Case 26/62. In the EC Treaty itself there are no stipulations as whether a provision is directly effective.

[891] See for the principle of direct effect, Hartley (1998) 187 ff.

[892] The principle of supremacy cannot be found in the EC Treaty but was established by the ECJ in its case law, particularly in the case *Costa v. Enel,* Case 6/64. For the principle of supremacy of Community law, see Hartley (1998) 218 ff.

[893] This can be derived from Art. 10 EC which requires Member States to fulfill the obligations arising from primary or secondary sources of law (positive Community loyalty), to facilite the achievement of the Community's tasks (positive Community loyalty) and to abstain from measures which could jeopardize the attainment of the objectives of the Community (negative Community loyalty). In particular, negative Community loyalty obliges Member States not to apply national tax provisions which conflict with Community law. See for the principle of loyalty, Joutsamo et al. (2000) 33-35.

[894] See van Thiel (2001) 3; Jiménez (1999) 206.

[895] See Terra – Wattel (2001) 2. In earlier tax literature some doubts were expressed as whether direct taxes may be affected by negative integration. However, it is settled case law that even direct tax measures applied by Member States can be affected by directly applicable Community law. For this discussion, see van Thiel (2001) 25 ff. Yet another driving force for harmonization of national tax laws is tax competition.

investment fund investments. In fact, there are various examples of national legislators in several Member States having repealed tax measures which are considered to be likely to conflict with Community law. For example, the Netherlands abolished, as of 2001, the difference between the taxation of income from resident investment funds and non-resident investment funds, which had discouraged investments in the latter by Dutch private investors.[896] In Austria, the Supreme Court recently declared the different treatment of interest income – as received through a domestic or through a foreign investment fund to the former's disadvantage – to be unconstitutional, and legislative changes will take place.[897] The most striking example is however Germany, where legislative changes of a fundamental nature took place as of 2004.[898] Only as of 2003, the Commission officially requested both Germany and Austria to put an end to discriminatory tax treatment of foreign investment funds.[899]

Secondly, the absence of case law in this field cannot be taken as an indication that national tax rules, applied by Member States to investment fund investments, would be fully compatible with Community law. Indeed, from many Member States examples can be found which show that the incompatibility of national tax rules is recognised by the legislator long before such rules are repealed. Often, a ruling by a national court or the ECJ is needed to effect the changes.[900] In Germany, too, the incompatibility of tax laws with Community law was recognised for a long time before the changes took place.

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[896] See Borsboom – Davidson (2001) 249.

[897] See Doralt (2003).

[898] In addition Portugal and Spain have abolished national tax rules likely to have been in conflict with Community law. See FEFSI & PricewaterhouseCoopers (2001a) 31.

[899] See EC Update, *European Taxation,* September 2003, EC-29. There are generally two ways in which the compatibility of a national tax rule with Community law may be brought before the ECJ. Firstly, a national court or tribunal may request a so-called preliminary ruling on the interpretation of a Community law provision and its impact on a national tax rule. See Art. 234(2) EC. To be more specific, a national court or tribunal either has the right to request a preliminary ruling, or is obliged to do so, depending on whether it is the final instance of a national judicial process or not. In the former case, a preliminary ruling must be requested. See for this distinction, Hartley (1998) 268-277. Secondly, the Commission may start a so-called infringement procedure under Art. 226 EC against a Member State, where it considers that a tax rule applied by the Member State does not comply with Community law. The infringement procedure may be divided into the administrative stage and judicial stage. The administrative stage may be subdivided into the informal and formal phase. In the informal administrative stage, the Commission will hold discussions with the Member State involved and try to reach a settlement on the issue. In the formal administrative phase, the Commission sends a formal request to the Member State to submit its observations on the issue, after which the Court may issue a reasoned opinion, formally recording the violation of Community law, unless the Member State voluntarily ends such violation. In the judicial stage, the Commission brings the violation of Community law before the ECJ. See for more details, Hartley (1998) 300-308.

[900] See, for example, Tumpel (2000) 34.

Finally, the absence of case law certainly does not mean that there will not be any case law: as in many important fields of of taxation, it is only a matter of time before the compatibility of national tax rules with Community law will be brought before the ECJ.

In this chapter, the two relevant fundamental freedoms, the free movement of capital and the freedom to provide services, in the context of investment funds and their investors are first examined. Subsequently, the discussion will turn to the case law of the ECJ involving income tax measures.[901] The purpose of the discussion is to serve as a basis for the examination of the impact of Community law on the tax treatment of investment funds and their investors in the Member States.[902] The discussion concentrates on clarifying the key issues which are relevant when examining the compatibility of tax measures applied by the Member States to investment fund investments. In view of incompatible tax provisions, a distinction is drawn between the cases of discrimination of non-residents, and of restriction, whether it may be a home-state- or a host-state matter. Subsequently, possibilities of justifying an otherwise incompatible tax measure under Community law are examined. This general discussion is followed by a survey of the case law on the provisions of the free movement of capital, and of the freedom to provide services, in order to gain the necessary insight into the Court's case law for the purposes of the subsequent examination.[903] The special question of the compatibility of tax treaties with Community law will finally be examined.

Following the general examination, the impact of Community law on the taxation of investment fund investments will be examined, in light of the findings of the examination. Several issues are explored, by using the tax measures applied by the Member States treated in this study as examples. First, the tax treatment of non-resident investment funds in the source state of income is examined. The discussion concerns itself with the compatibility of withholding taxes at source with Community law. Second, taxation of resident investors participating in foreign investment funds will be dealt with. The

[901] In view of the impact of Community law on national tax laws of Member States, the ECJ plays an important role. By virtue of Art. 220 and 234(1) EC, it has the jurisdiction to rule on the right interpretation of provisions of Community law and on the effect of such provisions in the national legal systems of the Member States. See Hartley (1998) 61 and 259. For the role of the ECJ particularly in tax cases, see Vanistendael (1996b) 114 ff.

[902] Meanwhile, a substantial body of case law involving direct tax measures has been developed by the Court. Within the limits of this study, it is neither necessary nor possible to describe all the cases in a detailed way. By contrast, there are several monographs where the cases are presented mainly in a chronological order. In particular, in van Thiel (2001) cases concerning the free movement of persons are examined in great detail. Other surveys on the case law of the Court can be found in Vapaavuori (2003) 109 ff; Pistone (2002) 103 ff; Jiménez (1999) 221 ff.

[903] On the other hand, other fundamental freedoms cannot be totally disregarded for the purposes of the study. In particular, much of the important case law of the ECJ in the field of direct taxes has been developed in respect of other fundamental freedoms than the above referred ones.

examination distinguishes between issues concerning the availability of certain tax benefits with regard to investment fund investments, and the anti-avoidance measures applied to investment fund investments. Third, the tax treatment of non-resident investors of domestic investment funds is examined, in view of withholding taxes at source and the eligibility of such investors for certain tax benefits. Finally, certain provisions of tax treaties having impact on the entitlement to treaty benefits by investment funds are discussed in light of Community law.

7.2 Relevant Fundamental Freedoms

Free Movement of Capital. Pursuant to the Maastricht Treaty, the free movement of capital and of payments is guaranteed by Article 56 EC, which states as a general rule that all restrictions on the movement of capital (Art. 56(1) EC) and on payments (Art. 56(2) EC) between Member States, and between Member States and third countries, are prohibited[904]. In the *Sanz de Lera* case, the ECJ confirmed that it has direct effect.[905] Article 56 EC aims at ensuring the free movement of the object of the protection rather than the individual entitled to the object.[906] As regards the scope of the article, the definition of the term 'capital movement' is therefore decisive as opposed to the qualities of the person involved in a transaction.[907]

Article 56 EC does not define the term 'capital movement'. However, the Nomenclature of the 1988 Directive contains a list of capital movements, comprising 13 separate categories. The Nomenclature is used by the ECJ as a means of interpretation when determining the scope of Article 56 EC.[908] The list is not considered exhaustive but merely an indication of the kind of transactions which can be considered as capital movements.[909] In view of investment funds, the list expressly refers to 'operations in units of collective investment undertakings' (category IV of the list). It further contains more detailed definitions of those undertakings for collective investment and those

[904] In line with the scope of this study, only the free movement of capital as between Member States is dealt with. It may be noted that the impact of Art. 56 EC on capital movements between Member States and third countries is less clear. There is so far no case law by the ECJ dealing with the matter. See Ståhl (2003) 585.
[905] *Sanz de Lera and others*, joined cases C-163/94, C-165/94 and C-250/94, para. 35.
[906] Sedlaczek (2000) 19.
[907] See Ståhl (2003) 586. This is of particular importance with respect to capital movements between the Member States and third countries, so that non-EU residents may also rely on the article.
[908] See, for example, *Trummer and Mayer*, Case C-222/97, para. 21; *Verkooijen,* Case C-35/98, para. 27.
[909] This can be read in the Nomenclature which specifically refers to 'other capital movements'.

operations which constitute capital movement within the meaning of Community law:

a) Units of undertakings for collective investment in securities normally dealt in on the capital market (shares, other equities and bonds).
b) Units of undertakings for collective investment in securities or instruments normally dealt in on the money market.
c) Units of undertakings for collective investment in other assets.
A.Transactions in units of collective investment undertakings
1. Acquisition by non-residents of units of national undertakings dealt in on a stock exchange.
2. Acquisitions by residents of units of foreign undertakings dealt in on a stock exchange.
3. Acquisitions by non-residents of units of national undertakings not dealt in on a stock exchage.
4. Acquisitions by residents of units of foreign undertakings not dealt in on a stock exchage.
B. Administration of units of collective investment undertakings to the capital market.
(i) Introduction on a stock exchange.
(ii) Issue and placing on a capital market.
1. Admission of units of national collective investment undertakings to a foreign capital market.
2. Admission of units of foreign collective investment undertakings to the domestic capital market.

Read in conjunction with Article 56 EC, it is clear that cross-border transactions with units of investment funds covered by this study are protected by the free movement of capital. It follows that Member States must abolish all restrictions which may prevent non-resident investors from acquiring units of domestic investment funds, and which may likewise prevent resident investors from acquiring units of foreign investment funds. Similarly, the Member States must allow domestic investment funds to issue and place their units in foreign capital markets, and foreign investment funds to issue and place their units in the domestic capital markets, without restriction.

Strictly speaking, it might be argued that the receipt of a profit distribution by an investment fund would not constitute capital movement but rather a payment.[910] However, the Court has interpreted the receipt of dividends as constituting capital movement, although this is not expressly included in the list of capital movements of the Nomenclature.[911] In the Court's view, to be classified as capital movement within the meaning of the EC Treaty, it is sufficient that a transaction may be linked to one of the operations expressly

[910] Cf. Ståhl (1996) 58, in relation to share investments.
[911] *Verkooijen*, Case C-35/98, para. 30.

mentioned in the list.[912] Analogously, the receipt of a profit distribution from an investment fund qualifies as capital movement, and is therefore protected by the free movement of capital. In any case, the distinction is not of particular relevance, since both the movement of capital and payments are covered by the same provisions.[913]

Article 56 EC providing freedom of capital movements is not without exceptions. Firstly, according to Article 58(1)(a) EC, Member States have the right to apply the relevant provisions of their tax laws, distinguishing between taxpayers who are not in the same situation with regard to their place of residence or the place where their capital is invested. The second exception in Article 58(1)(b) allows Member States to take all requisite measures needed to prevent infringements of their laws and regulations, in particular in the field of taxation.[914] When relying on the exceptions, one has to take account of Article 58(3) EC, according to which the measures referred to in Articles 58(1)(a) and 58(1)(b) EC may not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital.[915]

Freedom to Provide Services. Articles 49-55 EC ensure the freedom to provide services within the European Union by prohibiting any restrictions on provision of services. The provisions are applicable to service providers which are nationals of Member States, as long as services are rendered cross-border to a person situated in another Member State than where the service provider is established. Although the rules governing provision of services appear to address only service providers, the ECJ has held that they also cover recipients of services. In particular, prospective recipients of services may not be hindered or dissuaded from acquiring services.[916]

In accordance with Article 50 EC, the term 'services' within the meaning of the EC Treaty covers services that are provided for against remuneration, insofar as they are not governed by the provisions relating to the free movement of goods, capital and persons. Basically, marketing and distribution of units of investment funds seem to qualify as service within the meaning of the EC Treaty.[917] A unit of an investment fund essentially bears a proportional entitlement to assets managed by a management company on behalf of investors, against remuneration in the form of an annual management fee

[912] See *Verkooijen*, Case C-35/98, para. 28-29.
[913] See Sedlaczek (2000) 15. Prior to the Maastricht Treaty, capital movements and payments were dealt with in separate provisions of the EC Treaty.
[914] In addition, measures which are justified on the grounds of public policy or security can be applied by Member States.
[915] Due to this reservation, it is arguable that Art. 58(1)(a) and 58(1)(b) EC do not constitute true exceptions to the principle of free movement of capital. See Servais (1995) 61.
[916] See, for example, *Luisi and Carbone,* joined cases 286/82 and 26/83, para. 10.
[917] Art. 51 EC makes an express reference to banking and insurance services.

debited from the managed assets. Nevertheless, in accordance with the wording of Article 50 EC the provisions relating to services are clearly secondary to the other fundamental freedom provisions. Therefore, it is obvious that cross-border investment fund investments are primarily covered by the free movement of capital.

Overlap of Fundamental Freedoms. As regards financial services, it is not rare that the provisions concerning the movement of capital and free provision of services overlap.[918] Although not being consistent with the wording of Article 50 EC, it may be noted that the two provisions are not necessarily mutually exclusive. There is case law suggesting that the Court is willing to pay attention to the viewpoint of a service provider, despite the fact that another fundamental freedom is also applicable to the case under scrutiny.[919] For the purposes of this study, it seems appropriate to deal with both the provisions concerning the free movement of capital and the freedom to provide services. Whereas the free movement of capital is particularly suited for considering the impact of Community law on national tax measures from an investor point of view, the freedom to provide services serves better to highlight the viewpoint of the investment fund. Apart from that, it must be mentioned that the case law of the ECJ shows significant convergence in the interpretation and application of all four fundamental freedoms[920] so that a distinction between the fundamental freedoms has generally lost its significance.

7.3 Discrimination and Restrictions on Fundamental Freedoms in the Income Tax Case Law of the European Court of Justice

7.3.1 Discrimination of Non-Residents

Although the EC Treaty, and in particular the fundamental freedom provisions, do not expressly mention income tax measures, it has been clear since the *Avoir fiscal* case[921] of 1986[922]– the first case of the ECJ in the field of direct taxation – that even national income tax measures are covered by Community law. In its subsequent case law, the ECJ has repeatedly emphasized that

[918] This is because services performed by financial institutions often also involve a capital movement. See Peters (1998) 8.
[919] See Sedlaczek (2000) 17-18; Geurts (2000) 572.
[920] See Terra – Wattel (2001) 41.
[921] Case 270/83.
[922] The year stated after the case refers to the year in which the ECJ has delivered its judgment on the case, in order to make it easier for the reader to follow the development of the case law.

despite of the Member States having retained their competence in direct tax matters, the exercise of this competence is subject to Community law:[923]

> "[A]lthough, as Community law stands at present, direct taxation does not as such fall within the purview of the Community, the powers retained by the Member States must be exercised consistently with Community law."

Article 12 EC[924] and the fundamental freedom provisions generally prohibit discrimination on grounds of nationality.[925] With regard to companies, it is the registered office or seat of a company which serves as the connecting factor with the legal system of a Member State, as with nationality in the case of natural persons.[926] In case a Member State uses another formal criterion such as the country of registration of the entity, this would serve as the connecting factor.[927] In the field of tax law, the prohibition of discrimination on grounds of nationality is not unique, however, in that the OECD Model Convention in its Article 24(1) also contains a provision forbidding such discrimination.

In the field of income taxation, the criterion of differentiation is often the residence of the tax subject rather than the nationality.[928] In its early tax case law, the ECJ restated its doctrine of covert discrimination, prohibiting also discriminative national measures that do not differentiate on the basis of nationality but on some other criterion of differentation, but leading factually to the same end result.[929] In the cases *Biehl* of 1990 and *Commerzbank* of 1993,

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[923] See, for example, *Schumacker,* Case C-279/93, para. 12; *Wielockx,* Case C-80/94, para. 16; *Eurowings,* Case C-294/97, para. 32; *X and Y,* Case C-436/00, para. 32.

[924] It follows from the case law of the ECJ that Art. 12 EC, which contains a general prohibition of any discrimination on the grounds of nationality, applies independently only to situations which are not governed by fundamental freedom provisions. See, for example, *Halliburton Services,* Case C-1/93, para. 12; *Royal Bank of Scotland,* Case C-311/97, para. 20. As discussed earlier, the matters dealt with in this study are comprehensively covered by the fundamental freedom provisions. In practice, the case law of the ECJ shows that Art. 12 EC is often additionally invoked by the plaintiff, despite the matter at hand clearly falling within the scope of another EC Treaty provision. Very generally speaking, fundamental freedoms are applicable only to situations which involve economic activity. In the absence of economic activity, Art. 12 EC might be applicable. See Terra – Wattel (2001) 24.

[925] In Community law, the prohibition of non-discrimination, which in effect is the expression of the principle of equality, between Community citizens and companies on grounds of nationality, is a fundamental constitutional principle. See Hartley (1998) 149 ff; Wouters (1999) 98; Adonnino (1993) 30. In addition to Art. 12 EC, the principle of non-discrimination is enshrined in the fundamental freedom provisions of the EC Treaty. Depending on the provision, somewhat different expressions are used. Sometimes the prohibition of discrimination is expressly mentioned (as in Art. 39(2) EC). However, sometimes reference to abolition of restrictions is made (as in Art. 49(1) EC and 56 EC). The broad wording employed by the articles leave, however, no doubt that discriminatory measures are also prohibited.

[926] *Avoir fiscal,* Case 270/83, para. 18.

[927] Ståhl (2001) 254.

[928] None of the EU Member States subjects individuals to tax on the basis of their nationality. See van Raad (1995) 194.

[929] For the doctrine, see *Sotgiu*, Case 152/73, para. 11, where the Court states: "[…] forbid not only overt discrimination by reason of nationality but also all covert forms of discrimination which, by the application of other criteria of differentation, lead in fact to the same result." It further continued that

the Court stated that the use of the criterion of tax residence, in differentiating between taxpayers, is liable to work in particular against taxpayers who are nationals of other Member States.[930] This is because in most cases non-residents are also foreign nationals.[931]

Unlike overt discrimination (direct discrimination)[932] on grounds of nationality, the concept of covert discrimination (indirect discrimination)[933]on grounds of residence is of particular interest in the field of tax law, which typically distinguishes between residents and non-residents rather than between nationals and non-nationals. The concept of covert discrimination is also in conflict with the established principles of international tax law.[934] One of the basic principles of international tax law is the distinction between residents and non-residents for tax purposes. While resident taxpayers are subject to worldwide taxation in the residence state (unlimited tax liability), non-resident taxpayers are subject to tax only in respect of income deriving from sources in the state concerned (limited tax liability). Owing to this difference, the discrimination provision of Article 24(1) of the OECD Model Convention, for example, does not regard a distinction between residents and non-residents to the latter's disadvantage as constituting prohibited discrimination.[935]

It is settled case law that discrimination arises through the application of different rules to comparable situations, or through the application of the same rule to different situations.[936] In the field of income taxes, prohibited discrimination under Community law usually arises from the different

"[i]t may therefore be that criteria such as place of origin or residence of a worker may […] be tantamount, as regards their practical effect, to discrimination on the grounds of nationality[…]". For a more elaborate definition of covert discrimination see *O'Flynn*, Case C-237/94, para. 18 and 20 and extensive case law referred to.

[930] *Biehl,* Case C-175/88, para. 14 and *Commerzbank,* Case C-330/91, para. 15.

[931] In regard to natural persons, see *Biehl,* Case C-175/88, para. 14; *Schumacker*, Case C-279/93, para. 28. In regard to legal entities, see *Commerzbank,* Case C-330/91, para. 15. Although the Court seems to use the same line of reasoning in this respect for both natural persons and legal entities, there are differences between the cases. In the case of individuals, the residence for tax purposes is generally determined on the basis of factual residence, without regard to nationality, so that nationals may also be non-resident for tax purposes. However, in the case of legal entities, most states would deem all the entities having their seat or place of registration in that state resident for tax purposes. In such a case, domestic legal entities would never be affected by tax rules applicable to non-resident entities. See Ståhl (2001) 255.

[932] These terms are used interchangeably in the Court's case law. See Wouters (1999) 103.

[933] These terms are used interchangeably in the Court's case law. See Wouters (1999) 103.

[934] See Terra – Wattel (2001) 45-46.

[935] See Terra – Wattel (2001) 45-46.

[936] More generally, non-discrimination is also defined as a different treatment of similar situations, or as an identical treatment of two different situations. See, for example, *Schumacker*, Case C-279/93, para. 31; *Wielockx,* Case C-80/94, para. 17; *Asscher,* Case C-107/94, para. 40. See Jiménez (1999) 208, and particularly footnote 23, for the origin of the definition of non-discrimination in Community law.

treatment of comparable situations[937], rather than from the similar treatment of different situations. It follows, from the definition of discrimination, that only a different treatment of situations which are similar or comparable may constitute prohibited discrimination.[938] Whereas international tax law and the OECD Model Convention depart from the assumption that the situations of residents and non-residents *a priori* are not comparable[939], this is not the case in Community law. In its case law, the ECJ does not emphasize the concept of tax residence as established in international tax law and the OECD Model Convention[940], but rather examines whether the situations of the two categories of taxpayers (residents and non-residents) are factually comparable or similar. This may be called the 'comparability test' or the 'similarity test'.[941] From the case law of the ECJ, it becomes clear that a distinction made between resident and non-resident taxpayers under national tax law does not, as such, make the two categories of taxpayers incomparable for Community law purposes.[942] On the other hand, it is equally true that a distinction between resident and non-resident taxpayers does not in itself constitute discrimination, because there may be objective differences between the two categories of taxpayers[943], which essentially make the situations of residents and non-residents incomparable, not only for international tax law but also for Community law purposes. When assessing the situations of the resident and non-resident persons, it seems appropriate, based on the Court's case law, to distinguish between cases involving natural persons, on the one hand, and those involving legal entities, on the other.

When it comes to individuals, the ECJ has shown willingness to find a feasible compromise between international tax law and Community law.[944] In the *Schumacker* case of 1995 the Court established for the first time that in relation to direct taxes, the situations of residents and non-residents are, as a rule, not comparable.[945] In the *Wielockx* case of 1995 the Court confirmed this and delivered the following statement[946]:

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[937] See van Thiel (1994) 303.
[938] See, for example, Gammie (2003) 88; Jiménez (1999) 209; Knobbe-Keuk (1995) 236.
[939] See in particular the OECD Model Commentary, Art. 24 (1) para. 3 stating that "a taxpayer who is a resident of a Contracting State and one who is not a resident of that State are not in the same circumstances." See Gouthière (1994) 297, who states: "It is indeed very clear that, in the OECD's view, two taxpayers, one a resident and the other a non-resident, may be treated differently, the former better than the latter and that such discrimination is not prohibited by double tax treaties." See also Jiménez (1999) 187.
[940] Jiménez (1999) 209.
[941] See Terra – Wattel (2001) 46.
[942] See Lenz (1997) 82.
[943] Already in *Avoir fiscal*, Case 270/83, para. 19, the ECJ notes that a distinction based on the place of residence *could* be justified in an area such as tax law. See also *Wielockx,* Case C-80/94, para. 19.
[944] Terra – Wattel (2001) 46. See also Vanistendael (1994) 311.
[945] *Schumacker*, Case C-279/93, para. 31. This statement was largely seen as the Court's attempt to reconcile the prohibition of non-discrimination, as laid down in the EC Treaty, with the principles of

> "In relation to direct taxes, the situations of residents and of non-residents in a given State are not generally comparable, since there are objective differences between them from the point of view of the source of the income and the possibility of taking account of their ability to pay tax or their personal and family circumstances."

The state of residence normally has more information available about the aggregate income and the personal or family circumstances, in order to coordinate the taxation of persons in accordance with the ability-to-pay principle. By contrast, the source state of income, as a rule, finds itself in a far worse position for accessing such information, because typically neither the personal interests of a non-resident taxpayer nor his income is concentrated in the source state, but rather in the residence state.[947] However, the position of the source state and the residence state is different if the taxpayer exceptionally receives the major part of income in the former rather than the latter, so that the latter is not capable of taking into account the personal and family circumstances of the taxpayer.[948] Notably, in *Schumacker*, a non-resident employee derived the major part of his taxable income in the source state instead of his residence state with the result that the latter was not able to take account of the employee's personal circumstances, which led the non-resident employee to be in a comparable situation to that of resident persons of the source state.[949] In *Wielockx,* the same was true for a non-resident self-employed person.[950] As a consequence, in the Court's view, the source state had to grant a non-resident taxpayer equal treatment with resident taxpayers.[951]

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international tax law, in particular the principles of division of tax jurisdiction between the residence state and source state. See Wattel (1996b) 231-232; Lenz (1997) 82.

[946] *Wielockx,* Case C-80/94, para. 18 (with reference to *Schumacker*).

[947] See *Schumacker*, Case C-279/93, para. 32-33. As has sometimes been noted, this view is at least partly in conflict with the Court's approach of refusing to accept administrative difficulties as a ground of justification.

[948] Nonetheless, the main rule remains that the residence state of a taxpayer must take account of personal and family circumstances. This was clearly stated in *de Groot*, Case C-385/00, of 2002, where a residence state was obliged to grant a taxpayer (who received the majority of the income from employment from three other Member States but was not entitled to personal tax benefits in those Member States) tax benefits related to personal and family circumstances as if no foreign-source income were earned. See Mattsson (2003) 191-192. The Court's judgment (or the opinion of the Advocate General, to be specific) has been criticized on two grounds. First, the residence state was obliged to grant the tax benefits involved in full, although the income received from the other Member States was not taxable in the residence state. Second, the tax benefits at stake (alimony payments) may not exist in all the Member States. On the basis of the criticism, it has been suggested that the source states should take the tax benefits into account according to the proportion of the earned income to the total income. See Offermanns (2001) 39; Valat (2002) 448-449.

[949] See *Schumacker*, Case C-279/93, para. 36-37.

[950] See *Wielockx,* Case C-80/94, para. 20.

[951] The discrimination which would otherwise arise derives from the fact that the taxpayer's personal circumstances are not taken into account either in the state of residence (because he receives no income there) or in the state of source (on account of the absence of tax residency). *Schumacker*, Case C-279/93, para. 38; *Wielockx,* Case C-80/94, para. 21.

Although both the *Schumacker* and *Wielockx* case concerned the interpretation of the provision concerning free movement of persons, it was understood that the notion of a hypothetical dissimilarity of situations, as between residents and non-residents, would not be confined to free movement of persons, but would apply likewise to other fundamental freedoms as far as direct taxation is concerned[952], and that it would also be applicable to legal entities[953]. However, the subsequent case law shows that the Court's notion, concerning the hypothetically different situations of residents and non-residents, is maintained only in the case of individual taxpayers, and even then only as far as subjective tax benefits related to personal or family circumstances are concerned[954]. To the extent that individual taxpayers, with objective tax benefits related to a specific item of income at stake, and legal entities are concerned, it is arguable that the Court's point of departure is rather the hypothetical comparability of the situations of residents and non-residents.[955] In view of the subject of this study, the important question is: under which circumstances will the comparability or incomparability, as the case may be, of individual resident and non-resident fund investors, on the one hand, and resident and non-resident investment funds, on the other hand, be determined by the Court. These are the themes of the following discussion.

As regards individual non-resident fund investors, it is typically the objective tax benefits related to a specific item of income which are at stake in the source state.[956] The Court's case law shows that, in the case of objective tax benefits, the proportional concentration of the non-resident taxpayer's income, in the source state and residence state respectively, is not of significance when assessing the comparability of the situation with resident

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[952] See Thömmes (1995) 266.

[953] See van Raad (1995) 195, who deduces this from the Court's reference in *Wielockx* to the differences from the point of view of the source of income, which could be understood as referring to the limited tax liability of non-resident taxpayers as compared to resident taxpayers with unlimited tax liability.

[954] Terra – Wattel (2001) 48, use the term 'personal tax benefits', which refers to personal circumstances-related tax benefits such as basic tax allowances, splitting of income between spouses and deductions for personal and family circumstances. Van Thiel (2001) 471, in turn uses the term 'subjective tax elements', which is related to the personal or family circumstances.

[955] The distinction between subjective and objective tax benefits is emphasized by Terra – Wattel (2001) 48; Wattel (1996b) 232-233

[956] Only in a theoretical case, could there arise a situation where an individual's major part of income consists of investment income derived from another Member State, in which case it should be determined in line with *Schumacker* as to whether an individual investor is entitled to subjective tax benefits in the source state. The issue of subjective tax benefits in the case of investment income would only arise to the extent that the source state treats investment income as part of the aggregated income of the taxpayer, on the basis of which subjective tax benefits are conferred. Additional problems arise when the residence state of the investor would apply some other system of taxation, such as source taxation, in regard to investment funds, thereby excluding subjective tax benefits in respect of such income. For these considerations, see Vanistendael (1996a) 259-261.

taxpayers.[957] In *Biehl* the Court paid no attention to the concentration of income in the state of employment, when considering the situations of residents and non-residents in view of the right to a refund of overpaid income tax. It is even arguable that in *Schumacker* the Court did not take into account the concentration of income, to the extent that the procedure concerning annual adjustment of deductions at source in respect of wages tax was under consideration.[958] Nevertheless, the most notable case in this respect is *Asscher* of 1996. The issue under consideration was whether a Member State could impose a higher rate of income tax on income earned by a non-resident than on that earner by a resident. The Court found such unequal treatment discriminatory, without resorting to the comparison of residents and non-residents in terms of the concentration of their income in the Member States.[959]

As a consequence, it is arguable that, in the cases concerning objective tax benefits of individual taxpayers, the Court as a rule departs from the hypothetical similarity of the situations of residents and non-residents, though reserving to the Member States the possibility of providing evidence on the factual dissimilarity of the situations.[960] In view of the subject of this study, the fact that a non-resident investor derives only a minor part of his income in a particular source state does not suffice to allow the conclusion (*a contrario* from *Schumacker*) that the situations of a non-resident and resident fund investor are not similar.[961] As regards legal entities, the Court also seems to

[957] See Jann (1996) 55 who states: "[…] the comparability of a situation will be determined on the basis of whether the taxpayer derives all or almost all of his income in the State of residence only in cases where discrimination manifests itself through the denial of a personal deduction."
[958] *Schumacker*, Case C- 279/93, para. 48 ff. See van Thiel (2001) 471.
[959] See *Asscher,* Case C-107/94, para. 35 ff. The *Asscher* case is often considered as the most prominent example showing that the hypothetical dissimilarity of residents and non-residents, founded in *Schumacker* and *Wielockx,* is not to be understood as a general rule for Community law purposes, but is applicable only to certain restricted situations, in particular where subjective tax benefits are under consideration. See Terra – Wattel (2001) 51-52; Jiménez (1999) 238-239; Jann (1996) 55. See also van Thiel (2001) 471, who considers that the Court essentially departed from the similarity assumption despite also pointing to the dissimilarity rule as developed in *Schumacker.*
[960] See van Thiel (2001) 470-471. See also Lenz (1997) 85, according to whom an analysis on a case-by-case basis of the factual situations of residents and non-residents is always needed.
[961] Similarly, see Ståhl (1996) 205, in respect of non-resident share investors. Typically, the proportion of income earned in a particular source state to the total income of the taxpayer differs considerably as between a portfolio investor and an employee. While a portfolio investor typically may derive income from several source states, for an employee there generally, but not necessarily, is only one major source of employment income in the state of employment. Therefore, in the case of portfolio investors, it might also be argued that there is no objective difference, in terms of the source of income, between the situations of a resident and non-resident portfolio investor. Another argument against assimilating the case of portfolio investors to employees is that the division of taxing rights is fundamentally different in the two situations. While under the tax treaties, the taxing right of investment income is often divided between the source state of income and the residence state of investor (dividend, interest), in the case of income from employment the taxing right of income is often given to the source state of income. As a result, unlike in the case of employment, the final tax jurisdiction rests on the residence state, which therefore is in a position to coordinate the taxation of

base its assessment on the consideration that a non-resident entity subject to limited tax liability is in a similar situation to that of a resident company with unlimited tax liability[962], unless a Member State provides evidence to the contrary. The concentration of income in the source state is of no significance when comparing the situations of resident and non-resident entities.[963] In view of this study, the same should apply to investment funds.

Whereas in the case of subjective tax benefits the Court examines the whole tax position of the non-resident taxpayer, both in the source state and the residence state ('broad similarity test')[964], for objective tax benefit purposes – in the case of individuals as well as when legal entities are involved – the Court focuses only on certain relevant fiscal aspects in the source state ('narrow similarity test')[965].[966]

In *Avoir fiscal,* the Court compared a branch of a non-resident company and a domestic company merely on the basis of the way in which their taxable income was determined in the Member State, without regard to the non-resident's tax position in another Member State. The tax base being the same in both the cases, the branch was entitled to the same tax benefits (*avoir fiscal*) as the resident company.[967] In *Commerzbank* of 1993, the Court considered resident and non-resident companies comparable, in view of their eligibility for interest on overpaid tax. The fact that the non-resident company was not taxable on the item of income to which the tax payment was related[968] in the same way as resident companies was not, in the Court's view, of relevance.[969]

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the investor by granting relevant relief and allowances, as well as eliminating double taxation of income. The need for the source-country coordination as in the case of *Schumacker* therefore would not exist. For these considerations, see Vanistendael (1996a) 261-262.

[962] See Dautzenberg (2001) 2139; Jann (1996b) 169.

[963] See particularly Jann (1996) 55: "It would certainly be inappropriate in this connection to conclude that discrimination against enterprises would be acceptable in the course of profit determination if the enterprise does not derive all or almost all of its income in that state." See also Vapaavuori (2003) 274; Manninen (2000) 302.

[964] This term is used by van Thiel (2001) 465.

[965] This term is used by van Thiel (2001) 465.

[966] In light of the differences in the nature of the two categories of tax benefit, the Court's distinction between them becomes reasonable. While subjective tax benefits do not relate to a specific item of income but to the taxpayer's personal and family circumstances, a more delicate analysis of the taxpayer's whole tax position is needed in order to determine whether, and to what extent, such circumstances are taken, or should be taken, into account in the source state and residence state respectively. By contrast, objective tax benefits can be attributed to specific items of income, the earning of which they serve or to which they otherwise attach, and are therefore easier to allocate to source state and residence state income respectively. See Terra – Wattel (2001) 50.

[967] The Court particularly referred to the fact that the Member State's tax legislation made no distinction between branches of non-resident companies and resident companies, for the purposes of determining the income liable to corporation tax. In view of the Court, the Member State thus admitted that there is no objective difference between their positions. See *Avoir fiscal*, Case 270/83, para. 19-21.

[968] The income was exempted under the relevent tax treaty between the source state and Member State.

[969] See *Commerzbank,* Case C-330/91, para. 16-17. The Member State involved argued that for corporate tax purposes the situations of resident and non-resident companies were not comparable.

The position of the non-resident company was therefore equated with the resident company which also had overpaid tax, rather than with resident companies generally for corporate tax purposes.[970] In *Royal Bank of Scotland* of 1999, the Court clearly emphasized that the difference in the fiscal status (unlimited and limited tax liability) of the taxpayers does not prevent them from being in a comparable situation, as regards the method of determining the taxable base. In the case of a similar taxable base, the Member State was not allowed to impose a higher rate of tax on income received by a non-resident.[971] In a recent *Gerritse* case of 2003, the Court compared the situation of a foreign individual service provider with that of a resident service provider, for the purposes of deductibility of expenses from taxable business income in the Member State. The Court found the situations of the service providers comparable, as in both cases the business expenses were directly linked to the activity that generated the taxable income in the Member State.[972]

In light of the above, it must be considered whether the situations of resident and non-resident fund investors, on the one hand, and resident and non-resident investment funds, on the other hand, are, as a rule, comparable for Community law purposes.

In the case of fund investors, the decisive factor in assessing the similarity of situations is likely to be the determination of taxable income for the tax purposes in a given Member State. Should non-resident fund investors be taxable on their income derived within the Member State, along the same lines as resident fund investors, the similarity presumably exists, despite the different fiscal status and the different form of taxation imposed on the investors. Should however non-resident fund investors not be taxable on the income derived from the Member State, the similarity presumably cannot be maintained, to the extent that resident investors of the Member State are taxable on the same income.

In the case of investment funds, the starting point, as a rule, is somewhat different. Often resident investment funds are exempted from taxation in the Member State, in which case it is difficult to find arguments supporting the dissimilarity of the situations between resident and non-resident investment funds. In the exceptional case that the resident investment fund is taxable on its income in the Member State, the comparability would be determined along the same line of reasoning as adopted in the case of other taxable entities.

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[970] See van Thiel (2001) 466-467.
[971] *Royal Bank of Scotland,* Case C-311/97, para. 28-30.
[972] *Gerritse,* Case C-234/01, para. 25-27.

7.3.2 Home-State and Host-State Restrictions

It is notable that in its recent case law the ECJ has not only interpreted the fundamental freedoms as prohibiting overt and covert forms of discrimination, but also as prohibiting any other restrictions on the exercise of fundamental freedoms. This tendency has often been described as the movement from a discrimination-based approach to a restriction-based approach.[973] The restriction-based approach was initially introduced in the *Dassonville* case.[974] While *Dassonville* dealt with the free movement of goods and did not involve tax measures, the restriction-based approach was transposed gradually to other fundamental freedoms, and also to cover tax measures.[975] It is also notable that the ECJ has adopted the restriction approach even with respect to the provisions dealing with freedom of movement of persons[976] the formulation of which, strictly speaking, points to the prohibition only of discrimination.[977]

In any event, it is now settled case law that national tax measures which restrict fundamental freedoms, albeit not necessarily being discriminatory, may infringe Community law. The *Daily Mail* case of 1988, concerning the relocation of a registered office of a company to another Member State, is considered as the first example of the ECJ extending the restriction approach into the field of direct taxation. In *Daily Mail,* the ECJ first refers to Article 43 EC as a clause concerning the equal treatment of nationals and foreign nationals in the state of establishment, but then adds that the article also prohibits the state of origin from hindering its nationals from using their right of establishment in other Member States.[978] This interpretation of Article 43 EC has since been confirmed several times.[979] After *Daily Mail*, the ECJ has

[973] See van Thiel (2001) 7. Note, however, that in the Court's case law the distinction between discrimination- and restriction-based approaches is not always clear-cut. See Farmer (2003) 80, who notes that the Court sometimes uses language referring to a restriction-based approach, even though, based on the facts of a case, this could also fall within the discrimination-based approach. In principle, the notion of restriction may also be seen as a broader concept comprising discrimination. See Bergström – Bruzelius (2001) 235. However, it generally appears to be useful to draw a distinction between the concept of discrimination and that of restriction. See Terra – Wattel (2001) 41.

[974] *Dassonville,* Case 8/74, regarding Art. 28 EC prohibiting quantitative restrictions on imports and measures having the same effect. In *Dassonville*, the ECJ stated that the notion 'measures having the same effect' is to be interpreted as prohibiting "all trading rules enacted by Member States which are capable of hindering, directly or indirectly, actually or potentially, intra-Community trade."

[975] The restriction approach was first transposed to case law dealing with the freedom to provide services. See *Säger,* Case C-76/90.

[976] See *Kraus,* Case C-19/92, on the interpretation of Art. 39 and 43 EC.

[977] This is clear with respect to the wording of Art. 39 EC. However, the wording of Art. 43 EC can be understood to refer either only to the state of establishment or also to the state of the person using the right of establishment. In the latter case, Art. 43 EC would also literally contain the prohibition of restrictions. See Ståhl – Österman (2000) 85.

[978] See *Daily Mail,* Case 81/87, para. 16.

[979] See *ICI,* Case C-264/96, para. 21; *X AB and Y AB,* Case C-200/98, para. 26; *Baars*, Case C-251/98, para. 28.

confirmed the restriction approach to be also applicable to other fundamental freedoms, when scrutinizing the compatibility of national tax measures with Community law.[980]

As a very general rule, a national measure constitutes a restriction if it is liable to hinder, or otherwise impede, cross-border activity protected by the EC Treaty.[981] Restrictions, as opposed to discrimination, usually involve measures precluding or impeding the exercise of fundamental freedoms imposed by a Member State on its own nationals ('home-state restrictions')[982]. Home-state restrictions cannot usually be considered discriminatory within the conventional meaning of Community law, because they are applied only to resident taxpayers and therefore do not necessarily (although they may) affect non-nationals more than nationals. Instead of discriminating against non-nationals or non-residents, home-state restrictions discriminate against persons or capital exiting the home-state jurisdiction. The latter case is of utmost significance from the perspective of this study, and will be discussed in greater detail in Chapter 7.3.4. The following discussion explores the nature of restrictions, as opposed to discrimination, from a more general perspective.

The restrictions resulting from tax measures are generally indirect, in the sense that they do not directly prevent persons or capital from leaving the jurisdiction, but rather discourage such cross-border activity.[983] For example, a Member State may seek to discourage its own residents from taking up work in other Member States or establishing subsidiaries or branches in other Member States. It is also possible that a Member State discourages resident investors from making outbound investments in other Member States.[984]

Obviously, home-state restrictions are as harmful as discrimination, from the perspective of establishing the internal market.[985] After all, it is quite irrelevant whether it is the Member State where a person resides or another Member State it its capacity as a host state which hinders the person from using the rights guaranteed by the EC Treaty, since both are liable to impair

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[980] As regards Art. 39 EC, see *Terhoeve,* Case C-18/95, para. 39 and *Sehrer,* Case C-302/98, para. 33. Note that both *Terhoeve* and *Sehrer* are not pure tax cases but relate to social security. As regards Art. 49, see *Safir*, Case C-118/96, para. 23. As regards Art. 56 EC, see *Verkooijen,* Case C-35/98, para. 34.

[981] See, for example, *Säger,* Case C-70/90, para. 12.

[982] See Bergström – Bruzelius (2001) 235 and references there.

[983] See van Thiel (2001) 445-446.

[984] On the other hand, it is less likely that a Member State would discourage a service provider from providing services in other Member States.

[985] See *Commission of the European Communities v. French Republic*, Case C-381/93, on the interpretation of Art. 48 EC. In para. 17, the ECJ states that "[i]n the perspective of a single market and in order to permit the realization of its objectives, that freedom likewise precludes the application of any national legislation which has the effect of making the provision of services between Member States more difficult than the provision of services purely within one Member State."

the creation of the internal market. This was clearly expressed by the ECJ in the *Daily Mail* judgment[986]:

> "[…] the rights guaranteed by [Articles 43 et seq.] would be rendered meaningless if the Member State of origin could prohibit undertakings from leaving in order to establish themselves in another Member State."

As regards tax measures leading to home-state restrictions, they often take the form of granting certain tax relief or exemptions to persons or companies engaging in domestic activity, while denying them to those with cross-border activity. In the *ICI* case of 1998, the ECJ condemned the national legislation which made consortium relief dependent on the subsidiaries' seat, as a breach of Community law. In particular, consortium relief was available only to companies controlling subsidiaries whose seats were in the national territory.[987] Similarly, in the *X AB and Y AB* case of 1999, certain group contribution rules (which distinguished in their application between groups of companies having subsidiaries with and without seat in the concerned Member State to the disadvantage of the latter) were not compatible with Community law.[988] In the *Baars* case of 2000, national wealth taxation legislation was found to be not in conformity with Community law, because tax exemption from wealth taxes in respect of certain share holdings was made dependent on the shares being invested in companies established in the Member State in question.[989] In the *de Groot* case of 2002, the Court found a restriction when an employee lost a part of personal tax benefits in the residence state, owing to the fact that he had exercised his right to work in other Member States too.[990]

In the *Bachmann* case of 1992, rules which made tax deduction of insurance contributions conditional on the insurer's being established in the Member State in question were found to constitute, in principle, a restriction on the freedom to provide services, although the ECJ found a justification for such rules.[991] In the *Vestergaard* case of 1999, rules which made it more difficult to deduct costs relating to services performed outside the national borders than to those performed within the borders, were condemned as incompatible with Community law.[992] While these measures constitute home-state restrictions, from the perspective of service recipients, by discouraging cross-border

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[986] *Daily Mail,* Case 81/87, para. 16.
[987] See *ICI,* Case C-264/96, para. 22-23.
[988] See *X AB and Y AB,* Case C-200/98, para. 24-28.
[989] See *Baars,* Case C-251/98, para. 30.
[990] See *de Groot*, Case C- 385/00, para. 110.
[991] See *Bachmann,* Case C-204/90, para. 31 ff.
[992] Interestingly, in *Vestergaard,* Case C-55/98, the provider of services was resident in the same Member State as the recipient of the provided services, but the service itself was performed in another Member State. In this rather exceptional case the restriction in question could be regarded as home-state restriction.

acquisition of services, they also constitute, from the perspective of a service provider, discrimination against service providers established in other Member States by the host state.[993]

The home-state may also impose a higher tax burden on residents which have exercised their rights to operate in another Member State, rather than confining their activities within national borders. For the time being, there are no pure tax cases dealing with this type of restriction, but similar cases are found in the field of social security, which often shares some similarities with taxation. In the *Terhoeve* case of 1999, the fact that an employee, who worked part of the year in another Member State instead of his own Member State, had to pay higher social security contributions than if he had worked the whole year in his home state, constituted a restriction on the person's freedom of movement.[994] In the *Sehrer* case of 2000, a home-state restriction on free movement of persons was found when sickness insurance contributions were levied twice on the gross amount of the supplementary retirement pensions, in a situation when such a pension was derived from another Member State.[995]

Another category of restrictions comprises those imposed by a Member State on persons or companies accessing the Member State (host-state restrictions). Unlike home-state restrictions, host-state restrictions often also constitute discrimination, within the conventional meaning of Community law, in that they usually affect non-nationals, because the majority of accessing persons are non-nationals from other Member States rather than nationals.[996] However, there may also potentially occur host-state restrictions which do not constitute discrimination within the meaning of Community law. Generally

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[993] Gammie (2003) 90, captures the situation perfectly by stating that "[a] barrier from one party's perspective is discrimination from the perspective of the other party."

[994] See *Terhoeve*, Case C-18/95, para. 39-40. The higher contributions were due to the way in which the amount payable was determined under national legislation. In particular, social security contributions were assessed on the basis of taxable income, but there was an income ceiling in excess of which no further contributions were assessed. Mr. Terhoeve worked part of the year in another Member State thus being fiscally non-resident but continued to be covered by the social security of his own Member State, and he returned during the same year to his home state. Under national laws, social security contributions were assessed twice for persons, such as Mr. Terhoeve, who were part of the year fiscally non-resident, that is separately for the periods of non-residence and residence. However, in such a case the income ceiling was *not* adjusted, which resulted in the fact that for both periods, social security contributions could in principle be assessed on the basis of income up to the ceiling. Obviously, social security contributions then risk being higher in the case of transferral of residence during the year. However, such higher contributions did not lead to any extra social benefits.

[995] See *Sehrer,* Case C-302/98, para. 34. Sickness insurance contributions were levied twice because the Member State from which pension was derived had already levied such contributions on the gross amount of pension. However, there were doubts that the source state of pension also infringed Community law by levying such contributions. Since this question was not submitted by the national court to the ECJ for a preliminary ruling, the ECJ did not find itself in a position to examine it. See para. 12-21 of the judgment.

[996] Strictly speaking, such host-state restrictions are therefore not regarded as restrictions but as discrimination.

speaking, such host-state restrictions would result from tax measures which, even though applied without distinction to cross-border and domestic situations, effectively impede access to a Member State.[997] The only example of this sort of restriction in the field of tax law is found in the *Futura* case of 1997. In *Futura,* the Court found that the requirement that a non-resident company with a branch in the Member State must keep, for the purposes of carrying forward losses in that Member State, separate accounts with respect to the branch's activities, and must hold such accounts at the place of establishment of the branch, constituted a restriction of the freedom of establishment.[998] The obligation to keep separate accounts in the Member State, in order for non-residents to carry forward losses, could not be claimed as constituting discrimination, since resident companies wishing to carry forward losses were also under the same obligation.[999] Nonetheless, the ECJ concluded that such duty was more burdensome for non-residents, owing to the fact that these were also required to keep such accounts in their home states.[1000]

The *Futura* case also shows clearly that not only substantive tax measures, leading to a greater taxation of activities with a cross-border connection as compared to purely domestic activities, but also other more burdensome procedural rules imposed on cross-border activities, may result in restrictions under Community law. This was confirmed in the *Safir* case of 1998, where the ECJ found that obligations imposed on residents with insurance policies from non-resident insurance companies constitute a restriction on the freedom to provide services.

Finally, despite being potentially very far-reaching, the restriction-based approach has its limits. Strictly speaking, it is arguable that any tax measure imposed on economic activity, or on an economic actor, can potentially have a restrictive effect on cross-border activity, and can thus limit the exercise of fundamental freedoms within the Community.[1001] However, the restrictive effect of taxes is generally not dependent upon whether economic activity is

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[997] Van Thiel (2001) 448-449.

[998] See *Futura,* Case C-250/95, para. 23-26.

[999] See Jiménez (1999) 239. Note however that, apart from the case of carrying forward of losses, non-resident taxpayers were not obliged to keep separate accounts relating to their permanent establishment activities, and their taxable income was determined by an apportionment method.

[1000] See *Futura*, Case C-250/95, para. 24. Note also that the Court emphasised that tax accounts were required to be kept in accordance with the tax laws of the state of establishment, and that the accounts were to be held at the place of establishment and not at the company's seat.

[1001] See Farmer – Lyal (1994) 328-329; Ståhl – Österman (2000) 77. This derives from the commonly accepted presumption that the tax can never, in its effects on economic activity, be totally neutral. In other words, the tax imposed will always change the economic actors' behaviour from what it would have been if the tax had not been imposed. For further discussion, see Chapter 8.2.1.1.

confined within national borders or is of cross-border nature.[1002] It follows that even the restriction-based approach eventually calls for the application of the comparability test – or of the similarity test – employed by the ECJ in the application of the principle of non-discrimination.[1003]

While in the discrimination-based approach a comparison is made between resident and non-resident taxpayers, under the restriction-based approach a comparison must be made between the situations of a resident with a cross-border connection and a resident without such a connection.[1004] In *ICI* and *X AB and Y AB,* the ECJ compared the treatment between companies having subsidiaries in other Member States and those having solely domestic subsidiaries.[1005] Similarly, in the *Baars* case, it was, in the Court's opinion, essential to establish whether there was a difference in treatment between taxpayers who invested in companies in other Member States as compared to those investing in domestic companies.[1006] On the other hand, in both *Bachmann* and in *Safir,* a comparison was made between resident persons with insurance policies taken out with foreign insurers, and those with policies from domestic insurance companies.[1007] In *Vestergaard,* the Court examined whether there was a difference in treatment depending upon whether the service was performed within national borders or in some other Member State[1008]. Finally, in *Sehrer* the comparison was made between, in the Court's words, migrant and non-migrant workers[1009], and in *Terhoeve* and *de Groot* between employees working the whole year within national borders and those working part of the year in another Member State[1010].

In the case of individual portfolio investors, the comparability between resident taxpayers with and without cross-border investments may generally be assumed without a detailed investigation of the situations of the taxpayers. This is because residents are generally subject to worldwide taxation, so that the investment income and capital gains are taxable irrespective of whether they are sourced within the residence state or other Member States.

However, the situation might be different in a case where the tax treaty allocates the taxing right of the income exclusively to the source state; or

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[1002] Generally, it has also been argued that the ECJ has interpreted and applied fundamental freedom provisions in a somewhat more cautious manner in the field of tax law than in some other areas of law, when it comes to the restriction-based approach. See Ståhl – Österman (2000) 77.
[1003] See Gammie (2003) 90; Peters – Snellaars (2001) 17.
[1004] For the exceptional case of a host-state restriction, a comparison is made between a resident and non-resident as in the case of discrimination.
[1005] See *ICI,* Case C-264/96, para. 23; *X AB and Y AB,* Case C-200/98, para. 28.
[1006] See *Baars,* Case C-251/98, para. 30.
[1007] See *Bachmann*, Case C-204/90, para. 31; *Safir,* Case C-118/96, para. 24.
[1008] See *Vestergaard,* Case C-55/98, para. 21-22.
[1009] See *Sehrer,* Case C-302/98, para. 34.
[1010] See *Terhoeve*, Case C-18/95, para. 40 and *de Groot*, Case C-385/00, para. 83.

again in the case of a permanent establishment of a resident company, the income of which may be exempted, either under national law or a tax treaty, from taxation in the residence state of the company. The first mentioned situation was under consideration in the *de Groot* case. The Court, however, did not deal with a direct comparison between the situation of an employee deriving all the income from the Member State and that of an employee deriving income exempted under a tax treaty in the Member State from other Member States; rather, it relied on the *Schumacker* doctrine, according to which the residence state is primarily responsible for granting personal-related tax benefits.[1011] The latter mentioned case has been under consideration in the *Futura* case where the Court accepted a restriction on the possibility which would allow a non-resident company, as compared to resident companies, to carry forward losses in respect of income which is not subject to tax in the Member State.[1012]

7.3.3 Justifications

A discriminatory or restrictive national tax measure is permitted under Community law only if there is a justification for such an infringement. In its case law, the Court generally does not refer to a national measure being discriminatory or restrictive, prior to examining any possible ground of justification put forward by a Member State. Rather, the Court refers to such a measure as constituting either 'a difference in treatment' or 'an obstacle'. A justification put forward may be either one of the exceptions, or derogations, expressly allowed by the EC Treaty (hereinafter 'exception') or of those developed by the ECJ in its case law under the rule of reason ('justification').

As regards exceptions, Article 39 (freedom of movement for persons), Article 46 (freedom of establishment) and Article 55 EC (freedom to provide services)[1013] provide expressly public policy, public security and public health as possible exceptions. As far as these exceptions are concerned, it seems most unlikely that an incompatible tax measure could be justified by relying on

[1011] See *de Groot,* Case C-385/00, para. 98 ff. The resident employee was not entitled to any personal tax benefits in the states of employment under national tax laws or tax treaties. Nor was the proportion of income received from each Member State high enough to safeguard such benefits at source under the *Schumacker* doctrine.

[1012] See *Futura*, Case C-250/95, para. 18-22. Cf. also *AMID,* Case C-141/99, para. 22 ff., where the Court found no difference in the situations of a resident company and a resident company with a branch in another Member State, in respect of possibilities to carry forward losses incurred in the Member State, despite the fact that the income of the branch of a latter mentioned company was exempted from taxes in the Member State. For further comments on *AMID,* see Hinnekens (2001) and Avery Jones (2001b).

[1013] With respect to exceptions, Art. 55 EC refers to Art. 46 EC.

them. So far there is no such case law.[1014]Apart from them, Article 58(1)(a)-(1)(b) EC contains the reservations to Article 56 EC providing the freedom of capital movements. However, under Article 58(3) EC the measures referred to in these articles must not constitute discrimination or a restriction if they are to become permitted under Community law.[1015]

In addition to the exceptions laid down in the EC Treaty, the ECJ has, in its case law, developed the so-called rule of reason test.[1016] Since the treaty-based justifications are rarely appropriate in the field of tax law, the rule of reason test is often the only means of justifying otherwise incompatible tax measures. It is arguable that the Court developed the rule of reason test as a counterbalance to its wider interpretation of prohibitions enshrined in the fundamental freedom provisions.[1017] Based on the rule of reason, a measure that otherwise infringes on fundamental freedoms can be justified, provided that there is a mandatory requirement[1018] of general interest[1019]. Unlike the exceptions laid down in the EC Treaty, the justifications under the rule of reason test can, in principle, save only a covertly discriminating or otherwise restrictive national measure.[1020] However, this difference is not absolute, for there is some case law showing that even overtly discriminatory measures can potentially be justified under the rule of reason.[1021]

In view of the rule of reason, three criteria must be satisfied by a national measure, in order for it to become accepted under the test. In the first place, there must be a mandatory requirement of general interest pursued by the national measure which is capable of outweighing in importance the fundamental freedoms conferred by the EC Treaty. Secondly, the national measure must be appropriate or necessary[1022] for achieving the objective pursued. It is up to the Member State involved to prove the causal relationship between the restrictive measure and the protection of the public interest (the

[1014] See van Thiel (2001) 487; Ståhl – Österman (2000) 122; Gammie (2003) 92.
[1015] These provisions are dealt with in greater detail in Chapter 7.3.4 in the context of case law on the free movement of capital.
[1016] The concept rule of reason was introduced in the *Cassis de Dijon*, Case 120/78, in relation to the free movement of goods. Its application was in subsequent case law extended to cover other fundamental freedoms.
[1017] See Vapaavuori (2003b) 391.
[1018] The terminology is not totally settled. Sometimes the Court uses a somewhat different wordings such as 'imperative requirement', 'overriding requirement' or 'pressing reason'.
[1019] The terminology is not totally settled. Sometimes the Court uses the word 'public interest'.
[1020] See *Royal Bank of Scotland,* Case C-311/97, para. 32, where the Court states that the overtly discriminating measure under scrutiny can only be justified on grounds of the exceptions provided in the EC Treaty.
[1021] See, for example, *Avoir fiscal,* Case 270/83, para. 21, where the Court discusses the possibility of justifying overtly discriminating measures through scrutiny on grounds of other compensating benefits. See also *ICI,* Case C-264/96, para. 28, where the Court discusses the loss of tax revenue as a possible justification for overt discrimination. See also Farmer – Lyal (1994) 326-327; Wouters (1999) 104.
[1022] The terminology is not settled. Sometimes the Court also uses the term suitable.

necessity test). Finally, the principle of proportionality[1023] must be observed, in that the national measure must not go beyond what is necessary for the attainment of the objective (the proportionality test).[1024] In other words, the Court will not accept the restrictive measure if it is possible to obtain the same result by another, less restrictive, measure. Generally speaking, the ECJ has taken a very strict approach when applying the rule of reason test. Consequently, only rarely has a Member State been capable of justifying an otherwise incompatible national measure before the Court.

Most attempts of Member States to justify a national tax measure already fail in the absence of a qualifying mandatory requirement of general interest. In the course of litigation, the Member States have put forward a variety of justifications. However, the majority of these have been rejected by the ECJ. The readily rejected grounds of justification include the lack of harmonization in the field of income taxation[1025], concerns relating to the reduction of tax revenue[1026] and other reasons of a purely economic nature[1027]. In addition, general administrative reasons related to taxation have always been rejected by the Court as a possible ground of justification.[1028]

There are also other, perhaps more delicate, grounds of justification offered by Member States but rejected by the Court.[1029] Often, a Member State submits that a denial of a tax benefit is in any case partly or fully compensated

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[1023] In addition, the principle of proportionality forms a general principle of Community law. It is codified in Art. 5 of the EC Treaty according to which "[a]ny action by the Community shall not go beyond what is necessary to achieve the objectives of [the] Treaty." In this sense, the principle of proportionality serves to restrict the action by the Community organs. See Hartley (1998) 148-149.

[1024] See *Gebhard,* Case C-55/94, para. 37. See also, for example, Terra – Wattel (2001) 33; Ståhl – Österman (2000) 124-125; Farmer – Lyal (1994) 332-333. Both necessity and proportionality are essentially parts of the test of proportionality, but for the sake of clarity the test of proportionality may also be used in its narrower sense. However, it is equally correct to refer to the proportionality test in the sense that it covers both the necessity and proportionality of the measure. See Hartley (1998) 148, stating: "[proportionality] implies both that there exist a reasonable relationship between the end and means, and that the detriment to those adversely affected must not be disproportionate to the benefit to the public." It may be noted that the Court does not always distinguish neatly between the necessity, suitability and proportionality. See Prechal (1998) 5 footnote 21.

[1025] This was a common justification put forward by Member States in the earlier case law. However, already in *Avoir fiscal,* Case 270/83, para. 24, the ECJ held that the fact that the income tax laws of Member States have not been harmonized cannot justify discriminatory tax measures.

[1026] See *ICI,* Case C-264/96, para. 28; *Saint-Gobain,* Case C-307/97, para. 50; *Verkooijen*, Case C-35/98, para. 59; *Metallgesellschaft & Hoechst,* Joined cases C-397/98 and C-410/98, para. 59. For example, the refusal to grant certain tax concessions to non-resident tax subjects cannot be justified by the fact that such concessions cannot be later compensated by taxing corresponding income in the hands of non-resident tax subjects. See *X and Y,* Case C-436/00, para. 50; *Saint-Gobain,* Case C-307/97, para. 51.

[1027] See, for example, *Svensson,* Case C-484/93, para. 15; *Verkooijen,* Case C-35/98, para. 48.

[1028] See *Schumacker,* Case C-279/93, para. 43.

[1029] In the author's opinion, the following grounds of justification may be considered as more delicate in that they seem to follow established principles of tax law and therefore be more legitimate from the perspective of national tax systems. This does not, of course, as such make them more legitimate grounds of justification from the perspective of Community law.

by another tax advantage. In accordance with this view, the importance of considering the overall tax position of a taxpayer in the Member State, instead of a single tax measure, has been stressed by the Member States.[1030] However, the Court has rejected this justification consistently, by holding that unfavorable tax treatment in violation of the EC Treaty cannot be justified by the existence of other tax advantages in the Member State.[1031] Nor, in the Court's view, can a Member State justify a national measure by relying on the taxpayer's favorable treatment in another Member State.[1032] Hence, the approach generally employed by the ECJ is to scrutinize the compatibility of a national tax measure with Community law in isolation without paying attention to the overall tax position of a taxpayer.[1033] Finally, a Member State cannot make the compliance with Community law conditional on tax treaties.[1034]

Owing to the Court's strict approach, there are so far only three overriding requirements of general interest which have been accepted by the ECJ. They are i) the effectiveness of fiscal supervision, ii) the prevention of tax evasion and iii) the coherence of the tax system.[1035] Of these, the two first-mentioned grounds are often more or less overlapping, as the need to maintain effective tax control is closely connected to the prevention of tax avoidance or evasion.[1036] In the case of an accepted ground of justification, the Court further examines whether the necessity and proportionality tests are satisfied by a national tax measure.[1037] In the following discussion, the case law involving the accepted justification grounds will be examined in further detail. The aim is to specify the scope of the justification grounds and to examine the Court's application of the necessity and proportionality tests.

It is settled case law that the effectiveness of fiscal supervision counts among the general interests recognised under the rule of reason test.[1038] In the

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[1030] Vapaavuori (2003) 250.

[1031] See *Commerzbank*, Case C-330/91, para. 16-19. See also *Verkooijen,* Case C-35/98, para. 61, where further reference is made to *Avoir fiscal,* Case 270/83, para. 21; *Asscher,* Case C-107/94, para. 53; *Saint-Gobain*, Case C-307/97, para. 53.

[1032] See *Eurowings,* Case C-294/97, para. 44.

[1033] See Terra – Wattel (2001) 84-85; Ståhl – Österman (2000) 125. Apart from that, as Vapaavuori (2003b), 381, has correctly pointed out, in *Schumacker* and *Wielockx* the Court has taken the taxation in the resident state into account when assessing whether the non-resident person is in a comparable position to a resident person in a Member State.

[1034] See *Avoir fiscal,* Case 270/83, para. 26. The impact of Community law on tax treaties will be discussed in Chapter 7.3.6.

[1035] See, in particular, *X and Y,* Case C-436/00, para. 51.

[1036] However, this is not always the case. For example, the effectiveness of fiscal control may also serve to assess the right amount of losses to be carried forward or deductible costs.

[1037] See *Futura,* Case C-250/95, para. 26, where reference is made to *Gebhard*, Case C-55/94, para. 37; *Kraus,* Case C-19/92, para. 32; *Bosman,* Case C-415/93, para. 104. See also Terra – Wattel (2001) 32-33.

[1038] For the first time already in an indirect tax case *Cassis de Dijon,* Case 120/78, para. 8.

field of direct taxation, the justification on that ground was for the first time applied by the Court in the *Futura* case of 1997.[1039] In the subsequent cases, Member States have frequently relied on the effectiveness of fiscal supervision.[1040] The ECJ has admitted that a Member State is allowed to apply measures which enable the amount either of taxable income and of losses to be carried forward, or of deductible costs, to be ascertained clearly and precisely.[1041] Despite this, it has in practice never accepted otherwise incompatible tax measures on grounds of the fiscal control argument. In most cases, the measures aimed at ensuring effective fiscal control have failed to meet the test of proportionality.[1042] Often, the ECJ has referred to the Mutual Assistance Directive as an available means of ensuring fiscal control.[1043] Any claims concerning the inadequacies of the Mutual Assistance Directive have also been rejected.[1044] Consequently, the fact that it is possible for a Member State to rely on the Mutual Assistance Directive reduces the need to secure effective fiscal control by means of national measures.[1045]

The need to maintain the effectiveness of fiscal control is closely connected with the aim of preventing tax evasion or avoidance. Until recently the Court had not expressly referred to the prevention of tax evasion/avoidance as an admissible justification ground in the case law involving direct tax measures[1046]. Since the recent *X and Y* judgment from the year 2002, it is clear that the prevention of tax evasion also counts as one of the mandatory

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[1039] See *Futura*, Case C-250/95, para. 27.

[1040] For recent case law, see *Skandia,* Case C-422/01, para. 38 ff; *Danner,* Case C-136/00, para. 44 ff.

[1041] See *Futura,* Case C-250/95, para. 30; *Vestergaard,* Case C-55/98, para. 25.

[1042] For example, the ECJ has regarded non-deductibility of insurance contributions paid to foreign insurance companies as a disproportionate measure to secure effective fiscal control. See *Bachmann,* Case C-204/90, para. 20; *Danner,* Case 136/00, para. 51. Similarly, making tax deduction subject to different conditions, depending on whether a cost is incurred within the Member State or in another Member State, goes beyond what is necessary to ensure effective fiscal control. See *Vestergaard,* Case C-55/98, para. 25.

Yet, in some cases, the ECJ has rejected this justification based on the necessity test. See *Sandoz,* Case C-439/97, para. 35; *Lankhorst-Hohorst,* Case 324/00, para. 44.

[1043] See *Bachmann,* Case C-204/90, para. 18; *Futura,* Case C-250/95, para. 41; *Vestergaard,* Case C-55/98, para. 26.

[1044] See *Skandia,* Case C-422/01, para. 38 ff; *Danner,* Case C-136/00, para. 47 ff.

[1045] It may also be noted that the ECJ has consistently rejected administrative difficulties as a possible justification, by referring to the Mutual Assistance Directive. See, for example, *Schumacker*, Case C-279/93, para. 43-45.

[1046] Terra – Wattel (2001) 80. The issue of whether the ECJ would accept the risk of tax avoidance as a justification was raised in *Avoir fiscal.* In its judgment, the Court rejected the risk of tax avoidance as a possible justification, by stating that the applicable treaty article on the right of establishment did not permit any derogation on such a ground. See *Avoir fiscal,* Case 270/83, para. 25. Therefore, it could be inferred that the Court did not accept the prevention of tax evasion as a justification ground under the rule of reason test. However, the Court's rejection of the tax evasion argument has also been explained as resulting from the fact that, in the Court's view, there was no risk of tax evasion involved in the *Avoir fiscal* case. In the *ICI* case, too, the Court took the risk of tax avoidance briefly into consideration, but only noted that the national measure did not have the specific purpose of preventing tax avoidance. See *ICI,* Case C-264/96, para. 26.

requirements of general interest.[1047] Here it may be noted that the Court has not always distinguished strictly between tax evasion and tax avoidance, the terms being used interchangeably in the case law.[1048] Therefore, in the following, measures applied by the Member States with a view to preventing tax evasion and/or tax avoidance are referred to jointly as ‘anti-avoidance measures’.

In line with the strict interpretation of the rule of reason test, the Court has specified in detail the conditions under which anti-avoidance measures can be accepted under Community law. In the first place, the Court requires anti-avoidance measures to have as their purpose the prevention of – in the Court’s wording – wholly artificial arrangements aimed at attracting a tax benefit.[1049] The notion of ‘wholly artificial arrangements’ comes apparently close to the doctrine of abuse of Community law, as developed by the Court in its case law. According to this doctrine, private sector rights conferred by the EC Treaty may be denied in cases that can be qualified as an abuse of Community law.[1050]

Generally speaking, an abuse of Community law is present when there is an intention to obtain, through artificial schemes, benefits not intended for the economic actor, and when the granting of benefits would be at odds with the object and purpose of the Community rule invoked by the actor.[1051] The concept of abuse is also used in secondary Community law, in a direct tax specific context, in Article 1(2) of the Parent-Subsidiary Directive[1052], Article 5(1) of Interest-Royalty Directive[1053], and in Article 11 of the Merger Directive[1054].[1055] While the Parent-Subsidiary Directive and the Interest-

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[1047] See *X and Y,* Case 436/00, para. 51. The Court states: “[…] it is clear from the case-law of the Court of Justice that […] the prevention of tax evasion […] constitute[s] overriding requirement of general interest […]” Interestingly, the Court makes references to the case *ICI* so that it seems that the Court’s statements in the *ICI* were to be interpreted as meaning that the prevention of tax evasion counts as a justification ground under the rule of reason test.

[1048] This is clear from *X and Y,* Case 436/00, para. 51, referred to above. The Court makes reference to the cases *ICI* and *Metallgesellschaft & Hoechst* where the Court used the wording ‘tax avoidance’, when discussing the prevention of tax evasion. Also in *Leur-Bloem*, Case C-28/95, para. 44, the Court refers both to tax evasion and tax avoidance without distinguishing between them.

[1049] See *ICI,* Case C-264/96, para. 25; *Lankhorst-Hohorst*, Case C-324/00, para. 37; *X and Y,* Case 436/00, para. 62. Also the wording ’purely artifical schemes’ is used by the Court.

[1050] This was recently confirmed in *X and Y,* Case 436/00, para. 42.

[1051] See Terra – Wattel (2001) 83-84 and the case law referred to there.

[1052] Council Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ L 225, 20/08/1990 p. 6-9.

[1053] Council Directive 2003/49/EC on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, OJ L 157, 26/06/2003 p. 49-54.

[1054] Council Directive 90/434/EEC on the common system of taxation applicable to mergers, division, transfer of assets and exchanges of shares concerning companies of different Member States, OJ L 225, 20/08/1990 p. 1-5.

[1055] In addition, the concept of abuse is used in Art. 82 EC in a non-tax connection (competition rules). However, the article does not define the concept, though Art. 82(2) EC contains a list of examples of

Royalty Directive[1056] merely reserve to the Member States the right to apply national or treaty-based anti-avoidance measures[1057], the Merger Directive contains a more specific definition of abuse in the field of taxation.

> "A Member State may refuse to apply or withdraw the benefit […] where it appears that the merger […] has as its principal objective or as one of its principal objectives tax evasion or tax avoidance; the fact that one of the operations […] is not carried out for valid commercial reasons such as […] may constitute a presumption that the operation has tax evasion or tax avoidance as its principal objective or as one of its principal objectives."

Therefore, in the field of tax law, wholly artificial arrangements would be at least those which are made solely with the purposes of avoiding or evading tax without any valid commercial reason.[1058] On the other hand, it follows from the case law of the ECJ that tax planning aimed at using relative differences in tax burden between Member States cannot, as such, be regarded as abuse.[1059] Recently, in *X and Y*, the Court stated:[1060]

> "[T]ax evasion or tax fraud cannot be inferred generally from the fact that the[…]company or its parent company is established in another Member State […]"

As the second condition, the Court requires that the prevention of wholly artificial measures be the specific aim of anti-avoidance measures.[1061] This means that restrictive national anti-avoidance measures of a more general nature, covering in addition items other than wholly artificial arrangements, will not be accepted by the Court, since this would run against the principle of proportionality.[1062] To become compatible with Community law requirements,

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abusive conduct by undertakings. In addition, in an indirect tax context, the Sixth EC Directive mentions the concept of tax evasion and abuse in several articles. See Rädler et al. (1997) 97-98.

[1056] It reads: "This Directive shall not preclude the application of domestic or agreement-based provisions required for the prevention of fraud or abuse".

[1057] See Terra – Wattel (2001) 364, with respect to the Parent-Subsidiary Directive. See also *Denkavit,* Joined cases C-283/94, C-291/94 and C-292/94, para. 31, where the Court states: "It is to be noted that Article 1(2) of the Directive is a provision of principle, the content of which is explained in detail in Article 3(2) thereof." Article 3(2) of the Parent-Subsidiary Directive provides the Member States with the possibility of preventing short-lived concentration of non-qualifying holdings by providing a requirement of a holding period of minimum two years.

[1058] See *Leur-Bloem,* Case C-28/95, para. 47, where the Court defines the concept valid commercial reasons as involving more than the attainment of a purely fiscal advantage.

[1059] Terra – Wattel (2001) 84 and 367. See also van Thiel (2001) 492, who argues that in a case where the taxpayer intends to avoid or evade tax altogether, by way of invoking Community law, the Court could more easily find an abuse of Community law to be present.

[1060] *X and Y,* Case 436/00, para. 62.

[1061] See *ICI,* Case C-264/96, para. 26; *Lankhorst-Hohorst,* Case C-324/00, 37; *X and Y,* Case C-436/00.

[1062] See, for example, Körner (2003) 164; Lang (2002) 376. Examples of such anti-avoidance legislation generally include thin capitalization rules, which were under scrutiny in the *Lankhorst-Hohorst* case of 2002, CFC rules and transfer pricing provisions. See Körner (2003) 162. Note that anti-avoidance legislation does not necessary amount to discrimination, or to even a restriction, if it is applied similarly to both domestic and cross-border situations. It has been argued that the Court based

either a restrictive anti-avoidance measure should cover exclusively cases which consist of abuse; or, alternatively, there should be an escape clause for non-abuse cases.[1063] In regard to the latter, it is arguable that the ECJ could accept a presumption of tax avoidance, based on certain objective criteria laid down by an anti-avoidance measure, if combined with an escape clause for non-abusive cases.[1064] As regards an escape clause, it follows from the case *Biehl* that there must be a legal obligation, and not only discretionary powers, for the tax authorities to remove the discriminatory or restrictive impact of a national anti-abuse provision, in every case that does not qualify as abuse within the meaning of Community law.[1065] Therefore, a national anti-avoidance measure should obviously provide a taxpayer with an express possibility of rebutting any presumption concerning his abusive intentions.[1066] The role of national courts in assessing the existence of abuse was specified by the ECJ in *X and Y* as follows:[1067]

> "[T]he national courts may, case by case, take account – on the basis of objective evidence – of abuse or fraudalent conduct on the part of the persons concerned in order, where appropriate, to deny them the benefit of the provisions of Community law on which they seek to rely, but they must nevertheless assess such conduct in the light of the objectives pursued by those provisions […]"

In the *Bachmann* case of 1992, the Court accepted a novel tax-specific justification ground, namely the necessity of preserving the 'cohesion[1068] of the tax system'. However, it is remarkable that the *Bachmann* case was not

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its judgment in *Lankhorst-Hohorst* on the fact that the thin capitalization rules under scrutiny did not apply to domestic shareholders, but only to foreign ones. See Thömmes (2003) 188. It follows that in the case of non-discrimination or non-restriction, there is no need to attempt to justify such legislation under the rule of reason on the grounds of prevention of tax avoidance.

[1063] See *X and Y,* Case 436/00, para. 45 in respect of prevention of abuse of Community law, and para. 61 in respect of prevention of tax evasion. See also Weber (1997) 27.

In view of the vague definition of 'abuse' under Community law, an anti-avoidance measure should obviously not be very far-reaching as long as certain objective criteria, the existense of which trigger the application of the anti-avoidance measure, are laid down by a national measure. Ultimately, it is even arguable that national anti-avoidance rules should be drafted in such a way that they are not based on an automatic application but rather on a case-by-case evaluation. See Vinther – Werlauff (2003) 105.

For an attempt to clarify the concept of abuse under Community law by reference to different language versions of legal texts of the Parent-Subsidiary Directive and the Merger Directive, see Rädler et al. (1997) 99.

[1064] See also Gutmann – Hinnekens (2003) 95, who ask: "Can [the reluctance of the ECJ to accept anti-abuse rules] be overcome by a well-tailored and fine-tuned drafting of the rules in a manner that would preclude the application of the rules to non-abusive situations by a system of proof or counterproof of abuse or non-abuse?" This cannot be answered with certainty in view of the existing case law.

[1065] See *Biehl,* Case C-175/88, para. 18.

[1066] Similarly, Sullivan et al. (2003) 13.

[1067] *X and Y,* Case C-436/00, para. 42.

[1068] The terms cohesion and coherence are used by the Court synonymously.

only the first, but also to date the only, judgment by the Court where an otherwise incompatible tax measure could eventually be justified on grounds of the coherence argument. This follows from the fact that the Court has, in its subsequent case law, considerably specified the meaning of the concept. By doing this, the Court has reduced the possibility of reliance by Member States on the justification, by introducing new conditions which must be met by a tax system, or a tax rule, in order to be considered coherent under Community law. It is appropriate to look into the development of the concept in chronological order.

In the *Bachmann* case, the ECJ accepted the necessity of preserving the cohesion of the tax system, as a justification for a Member State's refusal to allow a tax deduction for insurance contributions paid by a resident person to a non-resident insurance company, even if such contributions were deductible when paid to a insurance company established[1069] in the same Member State. In the Court's view, the tax system was coherent, because there was a link between deductibility of contributions and the liability to tax on the income from the insurance policy. While the contributions were exempt from tax if there had been no deduction of contributions, they were liable to tax where there had been such a deduction.[1070] Since the ECJ could find no other, less restrictive, measure to guarantee the cohesion of the national tax system, it found the discriminatory tax measure justified.[1071]

The *Bachmann* judgment was heavily criticized, on the grounds that the Court had ignored the effect of the bilateral tax treaties concluded by the Member State.[1072] In line with the OECD Model Convention, the Member State had, in its tax treaties, waived its right to tax private pensions of non-resident beneficiaries, irrespective of their deductibility or non-deductibility in the Member State.[1073] It was further noted that the cohesion was not followed consistently in the Member State's internal tax legislation.[1074]

[1069] This meant that the insurance company was either incorporated under the Member State's laws or was a branch of a foreign insurance company. See, for the details of relevant Belgian tax provisions at the time, Knobbe-Keuk (1994) 79.

[1070] The Court further reasoned that the loss of revenue resulting from the deductibility of contributions from taxable income is offset by the taxation of capital or other sums paid under insurance policies. Therefore, the cohesion of the tax system required that if a Member State were obliged to allow a deduction of contributions paid to insurers established in other Member States, it should also be able to guarantee the taxation of the future income.

[1071] *Bachmann,* Case C-204/90, para. 21 ff.

[1072] See Thömmes (1996) 99. Part of the criticism was also unfounded. See, for example, Knobbe-Keuk (1994) 80-81 and Gouthière (1994) 302. Both authors refer to the fact that in the field of international taxation the deductibility of one item of income is not usually offset by a tax of comparable income. See Ståhl – Österman (2000), 129, who find such criticism groundless.

[1073] Knobbe-Keuk (1994) 80.

[1074] The Member State had agreements with three other Member States to allow the deduction of insurance contributions even though these were paid to insurers not established in the Member State. See Knobbe-Keuk (1994) 80.

The effect of bilateral tax treaties concluded by a Member State was taken into consideration by the ECJ in the *Wielockx* case of 1995. The *Wielockx* case concerned a Member State's refusal to allow a non-resident, self-employed individual a tax deduction, based on a contribution to a pension reserve under the same terms as a resident person. The Member State relied on the cohesion argument by pointing to the correlation between the sums which are deducted from the taxable income and the sums which are subject to tax. In contrast to resident persons, the liquidated pension reserve could not be taxed in the Member State, owing to the fact that the tax treaty between the relevant Member States would give the sole taxing right to the residence state of the non-resident person. However, the Court refused to accept the cohesion argument, on account of the lack of a strict correlation between the deductibility of contributions and the taxation of pensions in relation to the same person. In the Court's view, the Member State had in its bilateral tax treaty waived its right to tax pensions received by non-resident persons, even if they derived from contributions paid in that Member State. Correspondingly, it had reciprocally the right to tax pensions received by its residents, irrespective of the state in which the contributions were made.[1075] As a result of the *Wielockx* case, coherence of the tax system cannot be invoked, if a Member State has waived its national cohesion in relation to its tax treaty partner in order to reach bilateral cohesion.[1076]

In the *Svensson* case of 1995, the ECJ continued to clarify the conditions for the cohesion defence. In *Svensson,* the Member State refused to grant an interest rate subsidy to resident borrowers, in a case where the loan had been taken out with a bank established in another Member State. Under the Member State's tax system, interest rate subsidies were partly financed by means of profit tax on credit institutes. In the Member State's view, the cohesion of its tax system would be at stake, if the interest rate subsidy were also to be granted in respect of loans taken out with foreign banks, the profits of which are not subject to tax in the Member State. However, the Court did not accept this line of argument. Rather, it found that there was 'no direct link'[1077] between the subsidy and the profit tax on financial institutions.[1078] As a result, a mere macro-economic link between tax expenditure and tax revenue is insufficient in view of the coherence argument.[1079] Arguably, if a macro-

[1075] See *Wielockx,* Case C-80/94, para. 23 ff.
[1076] Terra – Wattel (2001) 75; Wattel (1996b) 242.
[1077] It is to be noted that the notion 'direct link', which in *Bachmann* appeared as 'connection' and in *Wielockx* as 'correlation', will be found in all subsequent cases involving the coherence defence. In particular, it is the nature of this 'direct link' which has turned out to be of paramount importance in assessing whether or not the preservation of coherence may be relied on as a justification.
[1078] *Svensson,* Case C-484/93, para. 18.
[1079] Terra – Wattel (2001) 71.

economic link were sufficient to invoke the coherence argument, Member States would have wide opportunities to justify any denial of tax benefits, by the fact that such benefits cannot be taxed back within the same tax system.[1080]

After declining categorically the coherence argument in several subsequent cases[1081], the quite recent cases *Baars* and *Verkooijen* from the year of 2000 provide important clarifications on the conditions under which the coherence argument can be relied upon. In the *Baars* case, the issue was whether a Member State's tax rules, which distinguished between resident and non-resident companies for the purposes of allowing an exemption from wealth tax, could be justified on the grounds of the cohesion of the tax system. The Member State argued that the exemption was granted in order to mitigate economic double taxation, arising first from corporate taxation of a company's profits, and subsequently by net wealth taxation of the assets invested in that company by its shareholder. Obviously, only profits of resident companies were subject to tax in the Member State, so that the exemption could be restricted to assets invested in resident companies. However, the Court rejected this line of reasoning. First, it noted that there is not even economic double taxation of profits, because wealth tax is levied on the value of shares (different income) rather than on the profits distributed (the same income). Obviously, the liability to net wealth tax was not affected by a company's profit-making. The Court did not therefore find a sufficient link between, on the one hand, the granting of exemption from wealth tax, and, on the other, the taxation of profits at the level of corporation. In the Court's view, there were two separate taxes (wealth tax and corporate tax) levied on two different taxpayers (shareholder and company).[1082]

In the *Verkooijen* case of 2000, a Member State put forward the cohesion argument in order to justify different treatment of dividend distributions on shares in resident and non-resident companies. The tax legislation of the Member State provided an exemption from income tax, up to a certain amount, for dividends received from resident companies, thereby excluding dividends distributed by non-resident companies. The line of argument resembled that in

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[1080] Dassesse (1996) 185. In fact, the Court's initial reasoning in the *Bachmann* judgment seems rather misleading, thus having perhaps given the Member State a different picture of the conditions under which the argument of the cohesion of the tax system may be invoked succesfully. In particular, the Court's statements in the *Bachmann* judgment that "[…] in such a tax system the loss of revenue resulting from the deduction […] is offset by the taxation […]" and "[t]he cohesion of such a tax system, the formulation of which is a matter for each Member State […]" seem to refer to the cohesion of the national tax system in whole. Rather surprisingly, in the *Bachmann* case, the ECJ also referred to the loss of tax revenue, notwithstanding that it has never accepted it as such as a justification for discriminatory tax measures. See also Thömmes (1996) 98, who considers that the *Bachmann* case caused a great deal of uncertainty and misinterpretations.

[1081] See *Asscher,* Case C-107/94, para. 59; *ICI*, Case C-264/96, para. 29; *Vestergaard,* Case C-55/98, para. 24.

[1082] *Baars,* Case C-251/98, para. 33 ff.

the *Baars* case, in that the aim of the exemption was to mitigate economic double taxation resulting from the taxation of the same profits, first at the company level and then at the shareholder level. The reason for the denial of the exemption, in respect of shareholdings in non-resident companies, was the fact that the latter are not taxed on their profits in the Member State, and hence there was no double taxation to be compensated for. Similarly to the *Baars* case, the Court rejected the cohesion argument, by finding no direct link between the exemption from income taxation at the shareholder level and the taxation of profits at the company level. In the Court's view, there were two separate taxes (personal income tax and corporate tax) levied on different taxpayers (shareholder and company).[1083] It has been argued that the importance of the *Verkooijen* case lies in the explicit statement by the ECJ that the cohesion argument cannot be invoked to justify a national measure, aimed at avoiding or reducing economic double taxation from a purely domestic viewpoint.[1084]

Since the *Verkooijen* case, the Member States have attempted to justify incompatible tax measures in the majority of cases by relying on the cohesion of the tax system. However, the Court has rejected this justification in all cases.[1085] Within the limits of this study, it is appropriate to deal here merely with the *Danner* case of 2002 which resembles the *Bachmann* case. The Member States put forward the coherence argument, in order to justify national restrictions on the tax deductibility of contributions paid to voluntary pension schemes taken out with insurance companies established in other Member States. The involved Member State argued, in line with the *Bachmann* case, that there was a direct link between the deductibility of contributions and the later taxation of pensions, the latter offsetting the loss of revenue resulting from the deductibility of contributions. However, the system applied by the Member State did not actually make the later taxation of pensions dependent on their tax deductibility, as was the case in *Bachmann.* Rather, the Member State also taxed, under its national tax law, pensions the contributions to which were not tax deductible for its own tax purposes but which were taxed in the hands of resident investors. Obviously, to achieve the cohesion of the tax system at the national level, the Member State should have exempted from taxation the pensions the contributions to which have not been deductible for tax purposes.[1086]

[1083] *Verkooijen,* Case C-35/98, para. 49 ff.

[1084] Lupo (2000) 274.

[1085] See *Metallgesellschaft & Hoechst,* Case C-397/98 and C-410/98, para. 61-73; *X and Y,* Case C-436/00, para. 52-59; *Lankhorst-Hohorst,* Case C-324/00, para. 39-42; *de Groot*, Case C-385/00, para. 106-109; *Skandia,* Case C-422/01, para. 30-37.

[1086] See *Danner,* Case C-136/00, para 33-43. In addition, the Court referred to the tax treaty between the involved Member State and that Member State in which the insurance company was established,

Altogether doubts have been expressed in several occasions as to whether the Court is any longer willing to accept in practice the cohesion of the *tax system* to justify national tax provisions conflicting with Community law, even though it is indisputable, from the Court's case law, that this justification is still formally recognized.[1087] These doubts may well be valid. However, it would still seem that there is a possibility of justifying a *single tax rule* to the extent that the requirements set out by the Court are fulfilled.[1088] Perhaps, to avoid confusion, it would be proper for the Court to update the terminology, in that only the cohesion of a national tax rule may serve as a justification ground.[1089]

7.3.4 Case Law on the Free Movement of Capital

Restrictions. Article 56 EC states as a general rule that all restrictions on the movement of capital between Member States and Member States and third countries are prohibited. The following discussion will, in line with the scope of this study, be limited to relationships between Member States.[1090]

The EC Treaty itself does not contain any further specification of restrictions that are prohibited under Article 56 EC. The wording "all restrictions" has been interpreted to mean that, under this article, not only discriminatory national rules but also any other rule which constitutes a restriction on the free movement of capital, irrespective of whether such a rule is discriminatory or not, would be forbidden.[1091] In this respect, Article 56 EC resembles of Articles 28 and 49 EC, which all are aimed at providing for the free movement of the object rather than of the individual entitled to the object.[1092]

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and nationality of which the resident insurance held; under this treaty the Member State had given up national coherence in favour of bilateral coherence. The Court's interpretation may not have been totally correct in respect of the taxing right of pensions between the Member States. However, this would not have changed the Court's decision. For more details, see Manninen – Rytöhonka (2003) 56-57.

[1087] See, for example, Vapaavuori (2003) 266; de Brabanter (2003) 170. It has also been argued that the cohesion argument would not be accepted in the case of *Bachmann* due to the Court's stricter approach to the necessity and proportionality tests. See Terra – Wattel (2001) 68.

[1088] See also Lyal (2003) 74, who is of the opinion that the cohesion is actually "an assessment of the respective situations of the two classes of taxpayers in order to determine whether they are comparable."

[1089] See also Vanistendael (2003) 193, who states: "For too long national tax administrations have seen the principle of coherence as a principle justifying broad compensation within the national tax system as a whole, linking different categories of taxpayers and of categories of income."

[1090] For discussion on the free movement of capital between Member States and third countries, see Ståhl (2003). As mentioned earlier, the free movement of payments under Art. 56 EC will also not be discussed separately.

[1091] See, for example, Sedlaczek (2000) 26; Gustafsson (2000) 673.

[1092] See Sedlaczek (2000) 19.

In its earlier case law, dealing with the interpretation of Article 67 (old) EC in conjunction with Article 1 of the 1988 Directive, the ECJ held that only direct restrictions on capital movements imposed by Member States are affected by the provisions of the free movement of capital. In the *Bachmann* case of 1992, a Member State's refusal to deduct insurance contributions paid to an insurance company established in another Member State, as opposed those paid to domestic insurers, was regarded only as an indirect restriction on capital movements, which was not prohibited under Community law. This was because the non-tax-deductibility of contributions did not altogether preclude insurance contributions to foreign insurers.[1093] Should this interpretation have been maintained, national tax measures could never have conflicted with the provisions of free movement of capital. This is because tax measures only have an indirect effect on the free movement of capital, in making it less beneficial, or more burdensome, to engage in a cross-border capital movement.[1094]

Meanwhile, it has, however, become clear that the distinction between direct and indirect restrictions has become obsolete in the assessment of the restrictive effect of tax measures on capital movements under Community law.[1095] In a non-tax case – *Svensson* of 1995 – the ECJ held that a provision, which was merely an indirect restriction on capital movements[1096], constituted a breach of the free movement of capital.[1097]

The concept of restriction, in relation to capital movements, under the new provisions of the EC Treaty (Art. 56 et seq. EC) was further clarified in the *Sandoz* case of 1999 concerning indirect taxation of loans. In *Sandoz,* the ECJ found that the imposition of a stamp duty on loans contracted in another Member State constituted a restriction ('obstacle') on the free movement of

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[1093] *Bachmann*, Case C-204/90, para. 34.

[1094] Peters (1998) 8.

[1095] See, however, Sedlaczek (2000) 20, contending: "[i]t may still be valid under Article 56 EC that a merely indirect restriction of the movement of capital and payments resulting from a restriction of another fundamental freedom being compatible with that fundamental freedom is not prohibited by Article 56 EC." The issue raised by Sedlaczek, however, relates to the question as whether a restriction which is compatible with another fundamental freedom may nevertheless be prohibited under Art. 56 EC. This will be discussed in the following section of the study dealing with the exception provided for in Art. 58 EC.

[1096] The provision under scrutiny required a bank to be established in a Member State, in order for a recipient of a loan to be eligible for an interest rate subsidy in the Member State. In the Court's view, the restrictive impact of such a provision arises from its discouraging residents of a Member State from taking out loans from credit institutions established in other Member States.

[1097] *Svensson,* Case C-484/93, para. 10. In the course of the *Svensson* litigation, the new provisions on capital movements pursuant to the Maastricht Treaty entered into force, though Art. 67 (old) EC in conjunction with the 1988 Directive were applicable in the *Svensson* case. Should the Court have maintained its interpretation in *Bachmann*, the tax-specific exception in Art. 58(1)(a) EC would have been redundant, because tax measures as indirect restrictions would never have been incompatible with the freedom of capital movements. See Peters (1998) 8.

capital.[1098] The stamp duty in question was applied irrespective either of the nationality of the contracting parties, or of the place where the loan is contracted, and therefore did not discriminate as such against foreign creditors. Despite that, the Court reasoned that, in the absence of such a stamp duty in other Member States, subjecting foreign loans to a stamp duty deters residents of a Member State from contracting loans with creditors of other Member States.[1099] As a result, the Court followed a strict interpretation of Article 56 EC, prohibiting all restrictions on capital movements between Member States even though cross-border activity was not restricted to a greater extent than domestic activity.[1100]

The first, and to date also the most prominent, case in the field of direct taxation involving the free movement of capital was decided by the ECJ in 2001. The national tax provision under scrutiny in *Verkooijen*[1101] was a tax exemption conferred on resident investors, up to a specified amount, for income from shares of companies established in the same Member State. Conversely, income from shares established in other Member States did not qualify for the tax exemption in the hands of resident investors. The Court found the national provision to constitute a restriction within the meaning of Article 56 EC.[1102]

The *Verkooijen* case is also an illustrative example of how comprehensively the Court scrutinizes the impact of national tax measures in relation to the free movement of capital. The fact that *Verkooijen* did not directly concern the interpretation of Article 56(1) EC, but rather Article 1 of the 1988 Directive, is not essential, since in accordance with the Court's view, Article 56(1) EC essentially codifies the contents of Article 1 of the 1988 Directive.[1103] In *Verkooijen*, the ECJ considered the impact of a national tax provision from the perspective of a domestic investor as well as from that of companies residing in other Member States. As a result, it found that the provision in question not only had the effect of dissuading domestic investors from investing capital in non-resident companies, but also constituted an obstacle for the latter to raise capital in that Member State.[1104] As a result, the requirement of free capital movements has both an inbound as well as an outbound dimension, from the perspective of a Member State. More precisely, a Member State is not allowed

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[1098] *Sandoz,* Case C-439/97, para. 20.
[1099] See *Sandoz,* Case C-439/97, para. 19.
[1100] See Ståhl (1999) 801. However, as will be explained in the subsequent section, the Court eventually found that the national measure in question fell within the exceptions provided for by Art. 58(1)(b) EC and was therefore eventually not in conflict with Community law.
[1101] Case C-35/98.
[1102] See *Verkooijen,* Case C-35/98, para. 34-36.
[1103] See *Trummer and Mayer,* Case C-222/97, para. 21.
[1104] See *Verkooijen,* Case C-35/98, para. 34-35.

either to hinder its own residents from investing into other Member States (home-state restriction), or to hinder non-residents from other Member States from investing into the Member State (host-state restriction).

Recently, in the *X and Y* case of 2002, the compatibility of national direct tax rules concerning share transfers was briefly examined in light of Article 56 EC, to the extent that the provision concerning freedom of establishment could not be applicable in the case.[1105] However, in view of the notion of restriction within the meaning of Article 56 EC, the case does not add anything new.

Finally, reference may be made to the pending case of *Manninen* submitted to the ECJ in 2002. The *Manninen* case involves the question as whether the denial of imputation credit under Finnish tax law, in respect of dividends received from non-resident companies, constitutes a restriction on the free movement of capital. In view of the existing case law, it seems clear that the denial of imputation credit constitutes an obstacle to the free movement capital by dissuading residents from investing cross-border. This is contrary to Community law, unless covered by the exception under 58(1)(a) EC, or unless justified under the rule of reason.

Exceptions. Due to the strictly drafted prohibition of restrictions on capital movements between Member States, the grounds for justifying otherwise restrictive national tax measures are of particular importance. In this respect, Article 58 EC expressly provides for exceptions to this prohibition as follows[1106]:

1. The provisions of Article 56 shall 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 […]
2. The provisions of this Chapter shall be without prejudice to the applicability of restrictions on the right of establishment which are compatible with this treaty.
3. The measures or procedures referred to in paragraphs 1 and 2 shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments as defined in Article 56.

Article 58 EC must be read so that a rule or measure that constitutes a restriction on free movement of capital may nevertheless be accepted, based

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[1105] *X and Y,* Case 436/00, para. 66-70.

[1106] Art. 58 EC is drafted in a different way from the provisions providing for exceptions to the free movement of persons or to freedom to provide services. At least to a certain extent, this may be explained by the Member States' fears of the growing impact of negative integration on their national tax systems. See Terra – Wattel (2001) 19.

on the grounds given in Article 58(1)(a), Article 58(1)(b) EC, or by way of Article 58(2), which contains a cumbersome reference to the admissible restrictions concerning the right of establishment[1107]. Nevertheless, the limits set out in Article 58(3) EC must in any case be additionally considered. In the following, the meaning of Article 58(1)(b) EC together with Article 58(3) EC is first explored. Then, the discussion turns to Article 58(1)(a) EC read in conjunction with Article 58(3) EC.

Article 58(1)(b) EC. Article 58(1)(b) EC, the wording of which follows closely Article 4(1) of the 1988 Directive[1108], allows Member States to take all requisite measures to prevent infringements of national tax laws.[1109] Neither the EC Treaty nor the 1988 Directive explain what the terms 'requisite measures' and 'infringements of national laws' mean for Community law purposes. From the wording it may however be inferred that 'infringements of national laws' essentially points to the scope of the exception permitted by Article 58(1)(b) EC. On the other hand, based on the Court's case law, it is clear that 'requisite measures' refers to the necessity and proportionality tests.[1110] As a result, the restrictive measure should be necessary to the purpose assigned to it (i.e. to prevent infringements of national tax laws) and should not go further than what is needed to attain this purpose.[1111]

In the *Sandoz* case of 1999, the ECJ made clarifications to the scope of Article 58(1)(b) EC.[1112] Interestingly, the question whether a restrictive tax measure could be justified under Article 58(1)(b) EC was raised twice. The first issue under scrutiny was whether the imposition of a stamp duty on loans

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[1107] As the right of establishment is not of significance in view of the subject of this study, it will not be discussed in more detail. For its meaning, see Peters (1998) 6-7; Scherer (1995) 182.

[1108] According to the Court, the exceptions provided for in Art. 58(1)(b) EC and Art. 4(1) of the 1988 Directive are essentially the same. See *Bordessa and others,* Joined cases C-358/93 and C-416/93, para. 22.

[1109] An express reference was obviously considered necessary because the removal of restrictions on capital movements was expected to lead to an increase in possibilities for tax evasion and avoidance. See Servais (1995) 56. In view of the abovementioned risks, Art. 6(5) of the 1988 Directive requested the Commission to make proposals which would aim at eliminating or reducing risks of distortion, tax evasion and tax avoidance with respect to savings. However, only recently, the Savings Tax Directive was adopted for such purposes.

[1110] *Sanz de Lera and others,* Joined cases C-163/94, C-165/94 and C-250/84, para. 23. See also Opinion of Advocate General Léger in *Sandoz,* Case C-439/97, para. 74-76 and 86-94. In the paragraphs referred to, he discusses whether a measure under scrutiny is "well suited to the purpose assigned to it" and "essential in order to prevent infringements of national laws". In paragraph 76 he also mentions expressly the principle of proportionality.

[1111] Even if not expressly referred to, the requirement of proportionality of national measures would be inherent in Art. 58(1)(b) EC. Sedlaczek (2000) 28.

[1112] In the non-tax cases *Bordessa and others* and *Sanz de Lera and others* of 1995, the Court held that the referred articles allow measures which are designed to ensure effective fiscal supervision and to prevent illegal activities such as tax evasion. *Bordessa and others,* Joined cases C-358/93 and C-416/93, para. 19 and 21 and *Sanz de Lera and others,* Joined cases C-163/94, C-165/94 and C-250/84, para. 22. Similarly also Commission v. Belgium, Case C-478/98, para. 38.

contracted in another Member State[1113], which in itself constituted an obstacle to the free movement of capital, may be regarded as a requisite measure within the meaning of Article 58(1)(b) EC.[1114] The involved Member State argued that the measure was justified by the need to ensure equal tax treatment of resident taxpayers.[1115] Indeed, in the absence of such a measure, resident taxpayers could avoid the stamp duty by taking out a loan from a credit institution established in another Member State. Somewhat surprisingly, the Court found that the measure under scrutiny was, in its words, essential in order to prevent infringements of national tax law.[1116] To support this, the Court delivered the following statement:

> "Since the effect of such a measure is to compel [persons resident in Austria who enter into a contract for a loan] to pay the duty, it prevents taxable persons from evading the requirements of domestic tax legislation through the exercise of freedom of movement of capital guaranteed by [Article 56 EC]."[1117]

What is surprising in the judgment is that the meaning which the Court has given to the definition of infringement of national tax law is different from the one generally adopted in the field of taxation.[1118] Traditionally, a distinction is drawn between tax evasion, occurring insofar as illegal action is involved to reduce the amount of taxes, and tax avoidance, occurring insofar as no illegal element is involved.[1119] Whereas both of these nonetheless potentially qualify as abuse under Community law, the activity referred to in the *Sandoz* case constituted, at most, normal tax planning. However, it seems that reliance on Article 58(1)(b) EC was practically the only way for the Court to avoid declaring a mere imposition of tax on cross-border activity to be a violation of Community law, after finding that it constituted an obstacle to free movement of capital.[1120] Therefore, the Court's reasoning in *Sandoz,* in respect of

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[1113] Please note that loan agreements were subject to stamp duty if contracted in a written document, irrespective of whether taken out from a domestic or foreign credit institution.

[1114] See *Sandoz,* Case C-439/97, para. 21.

[1115] *Sandoz,* Case C-439/97, para. 23.

[1116] *Sandoz,* Case C-439/97, para. 24. It seems, however, that the principle of proportionality at least was not expressly considered by the Court. However, Advocate General Léger concludes in his opinion that the principle of proportionality has not been violated. See Opinion of Advocate General Léger in *Sandoz,* Case C-439/97, para. 76.

[1117] *Sandoz,* Case C-439/97, para. 24.

[1118] See Ståhl – Österman (2000) 116 and 123.

[1119] See for the terms, IBFD, International Tax Glossary.

[1120] See also Ståhl – Österman (2000) 116. The Court's line of reasoning is confirmed in another non-tax case *Commission v. Belgium* of 2000, where the Court allowed the Member State to invoke Article 58(1)(b) EC in circumstances which clearly did not constitute tax evasion or tax avoidance. See *Commission v. Belgium,* Case C-478/98, para. 38 ff. In this case, a Member State sought to justify a prohibition of residents from subscribing a loan issued by the Member State on the Eurobond Market, the withholding tax upon the interest of which was waived by the Member State. In the Member State's view, the prohibition was necessary in order to prevent residents from being able to evade tax

infringement of tax law, can be accounted for by a different logic assumed by the Court in the context of Article 56 EC.[1121]

The second issue under scrutiny in *Sandoz* related indirectly to the same stamp duty on loans. Under the Member State's national law, an entry in the books of account was deemed to constitute a document equivalent to a written document, attracting the stamp duty liability, but only doing so in the case of a loan taken out abroad. The involved Member State argued that the objective of the measure was to ensure equal tax treatment of resident taxpayers regardless of where the loan was contracted. It referred to the prevention of residents from concealing the existence of a loan recorded in a written instrument abroad.[1122] However, the Court found the national measure to be inappropriate to attain the objective pursued.[1123]

Article 58(1)(b) in conjunction with Article 58(3) EC. Article 58(3) EC contains further requirements which must be satisfied, in order for an otherwise restrictive measure to be justified on grounds of Article 58(1)(b) EC. It follows that a requisite measure within the meaning of Article 58(1)(b) EC should not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital. The reference to arbitrary discrimination and disguised restriction is made also in Article 30 EC which provides grounds for justifying restrictions on the free movement of goods.[1124] The objective of the referred concepts is to prevent the abuse of justifications provided for by the EC Treaty.[1125]

In the *Sandoz* case, the matter under examination was whether an imposition of a stamp duty, qualifying as a requisite measure within the meaning of Article 58(1)(b) EC, constituted a means of arbitrary discrimination. In the Court's view, the requisite measure under scrutiny did not constitute arbitrary discrimination, because it applied without distinction as to nationality/residence or to the place where the transaction was carried out.[1126] Therefore, *a contrario* arbitrary discrimination would arise if a

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by subscribing to the loan in question. In particular, interest paid on loans issued on the domestic market was subject to a withholding tax. However, the Court found that the outright prohibition effected by the Member State did not comply with the principle of proportionality. In this respect, the Court noted that, despite the Member State's prohibition, nothing prevented residents from acquiring loans on the Eurobond Market of other issuers than the Member State, the interest payable on such loans not being subject to a domestic withholding tax in that Member State.

[1121] Under other fundamental freedoms, a mere imposition of tax has not been considered as a restriction if it applies without distinction to residence or place of invested capital.

[1122] See *Sandoz,* Case C-439/97, para. 33.

[1123] See *Sandoz,* Case C-439/97, para. 34-35.

[1124] Article 30 EC specifically states that "Such prohibitions or restrictions shall not, however, constitute a means of arbitrary discrimination or disguised restriction on trade between Member States."

[1125] See Peters (1998) 12. See also Joutsamo et al. (2000) 433.

[1126] See *Sandoz,* Case C-439/97, para. 26. See also the Opinion of Advocate General Léger, which clearly reveals that the reference to 'arbitrary discrimination' in Art. 58(3) EC is to be understood no

requisite measure is applied only to non-residents or cross-border situations, without having a national equivalent leading to the same result.[1127] Consequently, it seems that a national measure constituting an obstacle, but nevertheless being a requisite measure within the meaning of Article 58(1)(b) EC, would not infringe Article 58(3) EC, as far as comparable situations are treated similarly in its application. This could potentially mean that a Member State cannot justify a stricter anti-avoidance, or other, measure targeted to non-residents or foreign-source income, by relying on Article 58(1)(b) EC. If this is a correct interpretation, Article 58(3) EC obviously diminishes considerably possibilities of the Member States to rely on Article 58(1)(b) EC.

A disguised restriction on the free movement of capital is assumed if a restrictive measure, though disguised as a justified measure, nevertheless only amounts to a restriction.[1128] It has been questioned whether the notion of a disguised restriction in Article 58(3) EC is not redundant.[1129] This observation seems correct. In order for a measure to be recognized under Article 58(1)(b) EC, and subsequently to be subjected to a scrutiny under Article 58(3) EC, the measure must meet the necessity test. A measure amounting only to a restriction, without being necessary to ensure the objective pursued, already fails to qualify as requisite within the meaning of Article 58(1)(b) EC.

Article 58(1)(a) EC. Article 58(1)(a) EC provides that Article 56 EC is without prejudice to the Member States' right to apply the relevant provisions of their tax law, which distinguish between taxpayers who are not in the same situation with regard either to their place of residence, or to the place where their capital is invested. In a declaration annexed to the Maastricht Treaty it was affirmed that Article 58(1)(a) EC would apply only in respect of capital movements between Member States, and to the extent that relevant national tax provisions already existed at the end of 1993.[1130]

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more than as a prohibition of non-discrimination. See Opinion of Advocate General Léger in *Sandoz,* Case C-439/97, para. 78-80.

[1127] See Opinion of Advocate General Léger in *Sandoz,* Case C-439/97, para. 101 and reference to the point 55 there. The Advocate General discusses whether a provision, which deems an entry in the books of account to constitute a document equivalent to a written document which in turn attracts the stamp duty liability only in case of foreign loans, is compatible with Art. 58(3) EC. In his view, the provision fails to meet the requirements laid down in Art. 58(3) EC. According to him, the provision would be compatible with Art. 58(3) EC, provided that it applies to all resident borrowers irrespective ofwhere a loan is contracted. A similar conclusion was also drawn by Peters (1998) 12 prior to the *Sandoz* case.

[1128] See Sedlaczek (2000) 28 and reference there.

[1129] Sedlaczek (2000) 28.

[1130] Declaration no. 7, annex of the EC Treaty, reads "The conference affirms that the right of Member States to apply the relevant provisions of their tax laws as referred to in Art. 73 D, para. 1, a) of this Treaty will apply only with respect to the relevant provisions which exist at the end of 1993. However, this Declaration shall apply only to capital movements between Member States and to payment effected between Member States."

When Article 58(1)(a) EC was introduced, serious concerns were raised about its negative impact on the implementation of the free capital movements within the Community.[1131] However, the concerns have since turned out to be groundless. In the *Verkooijen* case of 2000, the ECJ confirmed that Article 58(1)(a) EC is to be seen as a mere codification of the case law already existing before the article came into force.[1132] In particular, the Court referred to the settled case law, that a national tax rule which distinguishes between taxpayers based on their residence or the place of invested capital, may be compatible with Community law, provided either that it applies to situations which are not objectively comparable, or if it may otherwise be justified by an overriding reason of general interest. Subsequently, the Court confirmed this view in the *X and Y* case of 2002.[1133]

Article 58(1)(a) in conjunction with Article 58(3) EC. By the same token, the Court referred to Article 58(3) EC which, in its view, specifically forbids national measures which constitute a means of arbitrary discrimination, or a disguised restriction on the free movement of capital, even if such measures would be permitted under Article 58(1)(a) EC.[1134] By this remark, the Court also rejected the arguments, raised by the Member State in *Verkooijen,* against the applicability of Article 58(3) EC to Article 58(1)(a) EC.[1135] Therefore, Article 58(1)(a) EC does not, in any case, contain an unconditional permission for Member States to apply national tax rules which distinguish between taxpayers based on their residence or the place of invested capital, because Article 58(3) EC requires that such rules must not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital. As the Court's statements in *Verkooijen* and later in *X and Y* suggest, national provisions distinguishing between taxpayers in a way defined in Article 58(1)(a) EC will be subject to the Court's scrutiny in line with the settled case law.[1136] As a consequence, even under Article 56 EC, a distinction

[1131] See, for example, Knobbe-Keuk (1992) 30; van Raad (1993) 221; Gouthière (1994) 302. In particular, the exception provided by Article 58(1)(a) EC was held to be remarkable, in that under the repealed Art. 67 (old) of the EC Treaty in conjunction with the 1988 Directive, Member States were obliged to abolish any discrimination based on the nationality or the place of residence, or on the place where the capital was invested.

[1132] *Verkooijen,* Case C-35/98, para. 43. Such a possibility was also brought forward by many authors. See, for example, Vanistendael (1994) 313-314; van Thiel (1994) 309; Ståhl (1996) 199. For the sake of clarity, it must be mentioned that Art. 58(1)(a) and 58(3) EC were not formally applicable to the *Verkooijen* case because the facts of the case took place prior to the Maastricht Treaty becoming operative. Despite this, the ECJ clarified its position even in respect of the abovementioned articles.

[1133] *X and Y,* Case C-436/00, para. 72.

[1134] See *Verkooijen,* Case C-35/98, para. 44.

[1135] See de Bont (1995) 139-140.

[1136] *X and Y,* Case C-436/00, para. 72. See also Ståhl – Österman (2000) 121. Similar reasoning appears already in the opinion of General Advocate in the *Baars* case: "[Article 58(3) EC] none the less states that such measures shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital […] It follows that the only distinctions which are

between taxpayers, on the basis of their residency or the place of invested capital, is not as such incompatible with Community law (Art. 58(1)(a) EC), but, if residents and non-residents are in a comparable situation, the difference in treatment is incompatible (Art. 58(3) EC) unless justified by an overriding requirement of general interest.[1137]

Rule of reason. Apart from the exceptions provided for in Article 58 EC, the Court's case law on Article 56 EC shows that the justifications based on the rule of reason test may, similarly to other fundamental freedoms, also be invoked in the context of Article 56 EC, without an express recourse to Article 58(1)(a) or Article 58(1)(b) EC. In particular, in addition to the effectiveness of tax control and prevention of tax avoidance, the cohesion of the tax system may be appealed to by a Member State in order to justify a measure restricting the free movement of capital.[1138] By the same token, it seems that recourse to Article 58 EC does not provide new grounds of justification for the Member States, but that the article merely serves as codification of the Court's prior case law.[1139] This is particularly highlighted by the *X and Y* case of 2002, where the Court disregarded the Member State's express recourse to Articles 58 (1) and (2) EC by delivering the following statement:

> "[T]he justifications relied on […] under Article 58 EC are essentially the same as those put forward to justify the restrictions on freedom of establishment […] which relate to the coherence of the tax system, the prevention of tax avoidance and the effectiveness of fiscal supervision […]"[1140]

Conclusion. Article 58 EC still provides the Court with a practical means of ensuring that national tax measures which do not discriminate between cross-border activity and domestic activity do not conflict with Community law, even if they are regarded as constituting an obstacle to the free movement of capital. This corresponds to the Court's approach with respect to other fundamental freedoms, in that the imposition of tax as such cannot be regarded as an obstacle within the meaning of Community law, as long as cross-border

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permissible are those which are required to maintain the coherence of the national taxation system." Note that in the *Baars* case the compatibility of national provisions with the freedom of establishment was the primary question and the compatibility with the free movement of capital only secondary. The Court did not finally consider it necessary to deal with the second question.

[1137] See Sedlaczek (2000) 24. Arguably the meaning given by the Court to Art. 58(1)(a) does not correspond to what was meant by the Member States when it was drafted. See Terra – Wattel (2001) 19; Gustafsson (2000) 677; Peters (1998) 6.

[1138] See *Commission v. Belgium,* Case C-478/98, para. 31; *X and Y,* Case C-436/00, para. 72.

[1139] See Lausterer (2003) 22. In principle, there would, however, be a difference between Art. 58 EC and the rule of reason test, in that the latter could, in principle, also justify measures which are overtly discriminating, though in such a case Art. 58(3) might be invoked by the Court. See Ståhl – Östermann (2000) 123. In any case, this difference is not likely to be of great significance as the Court has shown willingness to consider the rule of reason test, even in the case of overt discrimination, as mentioned earlier.

[1140] *X and Y,* Case C-436/00, para. 72.

activity protected by the EC Treaty is not treated differently from a comparable activity of a purely domestic nature. Should the national tax measure not be saved by Article 58 EC, the rule of reason may be relied on, as in the case of other fundamental freedoms, in order to justify an otherwise restrictive tax measure.

7.3.5 Case Law on the Freedom to Provide Services

Restrictions. Article 49 EC contains a similar prohibition, of restrictions on freedom to provide services, as does Article 56 EC in respect of capital movements. The scope of Article 49 EC extends beyond the prohibition of discrimination to any restriction on freedom to provide services, even if a restriction applies without distinction to national and non-national service providers.[1141] In practice, restrictive tax measures are prohibited under Article 49 EC only insofar as they constitute a more serious obstacle to the cross-border provision of services between Member States than to the provision of services within national borders of a Member State.[1142] The ECJ is willing to consider the restrictions imposed not only on service providers but also on recipients of cross-border services. The broad interpretation of Article 49 EC has been stressed by the ECJ even in the field of direct taxation:

> "In the perspective of a single market and in order to enable its objectives to be attained, [Article 49] likewise precludes the application of any national legislation which has the effect of making the provision of services between Member States more difficult than the provision of services exclusively within one Member State."[1143]

In the *Bachmann* case of 1992, the question arose as to whether a Member State's national tax rule – making the deductibility of certain insurance contributions dependent upon the insurance company being established in that Member State – was incompatible with Article 49 EC. The Court held that the rule discouraged residents of the Member State from taking out an insurance policy with insurance companies established in other Member States, thus constituting a restriction of the latter's freedom to provide services.[1144] Along the same line of reasoning the Court also decided two more recent cases. The case of *Danner* in 2002 concerned itself with a national tax rule restricting the deductibility of contributions to voluntary pension schemes taken out by

[1141] See *Säger*, Case C-76/90, para. 12.

[1142] See also Ståhl – Österman (2000) 77.

[1143] See *Skandia,* Case C-422/01, para. 26; *Danner,* Case C-136/00, para. 29.

[1144] *Bachmann*, Case C-204/90, para. 31. Nonetheless, the ECJ eventually found justification for the rule applied by the Member State.

residents with companies established in the same Member State.[1145] In the *Skandia* case of 2003, a Member State distinguished between insurances taken from companies in the Member State and in other Member States, for the purposes of the moment of tax deductibility of paid contributions, to the disadvantage of the latter.[1146] In both the cases, the national tax measure, distinguishing between insurances taken out with companies established in the Member State and those contracted with companies in other Member States, was considered an infringement of the freedom to provide services.

The *Safir* case of 1998 brings an important contribution to the interpretation of Article 49 in the field of direct taxation. In the *Safir* case, a Member State applied different tax regimes for capital assurance policies, depending on whether these were taken out with companies established in the Member State or with non-resident companies from Member States. In the former case, the insurance company rather than the policy-holder was liable to tax on the yield, calculated by a standard method based on the assets and liabilities of the company and the average government bond yield. At the level of policy-holders, premiums paid were neither deductible nor taxable. In contrast, if the capital assurance policy were taken out with an insurer established abroad, the policy-holder himself was obliged to pay a tax of 15 per cent, calculated on the basis of the paid premiums ('premium tax').[1147] In addition, the policy-holder was required, for premium tax purposes, to register himself with the tax authorities and to declare the payment of premiums.

Based on the facts of the *Safir* case, the ECJ concluded that the different tax regimes applied by the Member State to capital assurance policies constituted a breach of Article 49 EC. The Court found several elements which were liable to discourage nationals from taking out foreign capital assurance policies (home-state restriction). By the same token, insurance companies from other Member States were discouraged from offering their services on the market in the Member State involved (host-state resitriction).[1148] Significantly, most of the restrictive elements of tax legislation did not directly

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[1145] *Danner,* Case 136/00, para. 30-31. In legal literature, the applied restriction was already earlier found to be in conflict with Community law. See Penttilä (1996b) 381 ff; Ossa (1999) 308 ff.

[1146] *Skandia,* Case C-422/01, para. 27-28.

[1147] To ensure that holders of foreign capital assurance policies would not be subject to a greater tax burden than those having domestic policies, the tax authorities had discretionary power to grant a full or partial exemption from tax, in a case where the foreign insurer was already subject to a tax comparable to that imposed upon domestic insurers in its residence state. The premium tax was reduced by half if the foreign tax applicable to the insurance company was at least one quarter of that applicable to domestic insurers. A total exemption from tax was granted if the foreign tax amounted to at least a half of the tax on domestic insurers. See *Safir,* Case C-118/96, para. 3-12 and 24.

[1148] *Safir,* Case C-118/96, para. 30.

relate to tax burden[1149] but to procedural aspects of tax rules[1150]. The latter included, among others, registration duties and a burdensome procedure of applying for a possible exemption from premium tax[1151].[1152] The Court's strict approach, in scrutinizing not only the amount of tax burden but also other liabilities, seems reasonable in view of the fact that any additional liabilities may be relatively costly to individuals. Hence, their dissuading effect can well compare to that of a heavier tax burden.

In the *Vestergaard* case of 1999, the Court examined national measures which distinguished between professional courses held within the Member State and in other Member States, in relation to the deduction of costs relating to such courses from taxable income. More precisely, the deductibility of costs relating to professional courses, arranged in an ordinary tourist resort abroad, was made conditional upon the rebuttal by the taxpayer of a presumption that such a course involves such a significant tourism element that the costs cannot be treated as deductible operating cost. In contrast, for courses held in an ordinary tourist resort within the Member State, there was no such presumption. The Court found that the difference in treatment based on the location where the service is provided was contrary to the freedom to provide services.[1153] In particular, the presumption applied to courses arranged in other Member States was liable to make the deduction of costs more difficult than in a case where the course was taken within the Member State. [1154]

[1149] The Court only found that surrending a policy after a short period of time would be more costly for persons with foreign insurance policies as compared to those with domestic ones. See *Safir,* Case C-118/96, para. 27.
Owing to the very technical nature of the tax rules under scrutiny in *Safir*, it was difficult to determine whether the taxation of domestic and foreign capital assurance policies was neutral in terms of total tax burden. Therefore, the Court could also not declare the Member State's tax rules to be outrightly discriminatory, but focused on the practical side of the application of such rules. Although the taxpayer has the possibility of obtaining an exemption from premium tax under certain conditions, such a possibility did not sufficiently guarantee that persons with foreign policies were not subject to a higher taxation than those with domestic ones. In this respect the Court referred to a 'threshold effect' which arose to the extent that the tax paid by the foreign insurer was not fully taken into consideration when determining the premium tax payable by the policy-holder. Indeed, if the tax paid by the foreign insurance company did not amount to one quarter, no reduction of premium tax was available. See *Safir,* Case C-118/96, para. 31. On the other hand, it is arguable, albeit not mentioned by the Court, that in some cases the tax burden on foreign policies might well turn out to be smaller than on domestic policies.

[1150] See Pistone (2002) 132.

[1151] The policy-holder had to supply the necessary information concerning the income tax regime applied to the foreign insurance company, unless the tax authorities already had such information.

[1152] See *Safir,* Case C-118/96, para. 26 ff.

[1153] *Vestergaard,* C-55/98, para. 22.

[1154] Recently, the Court also decided the case *Gerritse,* Case C-234/01, based on the provisions of freedom to provide services. The *Gerritse* case involved a non-resident service provider whose treatment, as regards the availability of certain tax deductions and tax benefits under the withholding tax procedure applied by a Member State, was under consideration. However, owing to the fact that the *Gerritse* case is of significance in view of the tax treatment of non-residents in the Member State

Justifications. In accordance with Article 55 EC, the specific exceptions to the right of establishment laid down in Article 46(1) EC, including public policy, public security and public health, also apply to the provision of services. However, they are unlikely to have significance in the field of direct taxation. As in the case of other fundamental freedoms, discriminatory or restrictive tax measures may also be justified under the rule of reason test.[1155] In that regard, it is appropriate to point out that a Member State cannot justify a less favorable tax treatment of non-resident service providers by relying on their favorable tax treatment in another Member State as compared to domestic service providers in the Member State.[1156]

7.3.6 On Tax Treaties and Community Law

Tax treaties are international agreements which every sovereign state may conclude by virtue of its constitutional and international independence.[1157] The Member States' competence to conclude tax treaties amongst themselves is expressly confirmed by Article 293 EC, which provides that Member States shall, so far as necessary, enter into negotiations with each other with a view to securing, for the benefit of their nationals, the abolition of double taxation within the Community.[1158] There is also little doubt that Member States are, in the absence of Community measures in the field of direct taxation, still competent to negotiate and conclude tax treaties with third countries which are not members of the EU.[1159]

Apart from the issue of competence to negotiate and conclude tax treaties, the exercise of the powers retained by the Member States must be considered. It is clear from the case law of the ECJ concerning international treaties[1160], and in particular tax treaties[1161], that Community law prevails, in accordance with the principle of primacy of Community law, over incompatible provisions of tax treaties concluded by Member States. As a consequence, the provisions and application of tax treaties may be restricted by Community law

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generally, rather than from a perspective of the provision concerning the freedom to provide services, it will be dealt with in Chapters 7.4 and 7.6.

[1155] See *Stichting Collectieve Antennevoorziening Goudas*, Case C-288/89, para. 13.

[1156] See *Eurowings,* Case C-294/97, para. 44; *Danner*, Case C-136/00, para. 56.

[1157] Lehner (1996) 3.

[1158] This was also confirmed by the Court in *Gilly,* Case C-336/96, para. 24 and *Saint-Gobain,* Case C-307/97, para. 56. See also Scherer (1995) 73. For a more detailed discussion of the allocation of competence to abolish double taxation within the Community, see Lehner (1996) 3 ff.

[1159] Prechal (1998) 12.

[1160] See references to such case law, Hinnekens (1994) 146.

[1161] *Gilly,* Case C-336/96; *Saint-Gobain,* Case C-307/97.

whether primary or secondary.[1162] As for the tax treaties concluded between the Member States, Community law takes precedence over incompatible provisions, irrespective of whether the treaty was concluded before or after the entry into force of the EC Treaty or, as the case may be, the date of accession of the Member State to the Community.[1163]

The relationship between Community law and tax treaties generally was dealt with in the *Gilly* case of 1998 and later in the *Saint Gobain* case of 1999. According to this line of case law, the Member States are competent to determine the criteria for taxation of income, with a view to eliminating double taxation by means, for example, of tax treaties.[1164] In the context of tax treaties, the Member States are therefore free to determine the connecting factors, for the purposes of allocating powers of taxation as between themselves.[1165] In this regard, the Court has, to a certain extent, paid attention to whether a Member State follows the widely-accepted principles of the OECD Model Convention. It seems that distributive rules[1166] which correspond to international standards as laid down in the OECD Model Convention are, as a rule, compatible with Community law.[1167]

In any case, it is arguable that the issue of allocating taxing powers between jurisdictions is secondary to the exercise of the allocated powers, the latter being for the most part the decisive factor, in view of the possible

[1162] Scherer (1995) 107 ff.

[1163] See Terra – Wattel (2001) 112; Scherer (1995) 54-55. As far as tax treaties concluded by a Member State with a non-member state are concerned, a distinction between treaties concluded before and after the entry into force of the EC Treaty, or of the date of accession, must be drawn. In view of the aforementioned, Art. 307 EC provides that such tax treaties are to be respected. To the extent that such tax treaties are incompatible with Community law, the Member State involved is however obliged to try to renegotiate the conflicting provisions. See for this effect, Prechal (1998) 13. In view of the latter case, Art. 307 EC is usually interpreted to mean that a Member State may not conclude a tax treaty which is incompatible with Community law, without failing to fulfil its obligations under Community law. See Terra – Wattel (2001) 112; Scherer (1995) 139. In accordance with Art. 10 EC, Member States must abstain from any measure which could jeopardise the attainment of the objectives of the Community. See for this effect, Hinnekens (1994) 148.

[1164] This is subject to the Community not taking any positive measures in this regard, in particular under Art. 293 EC.

[1165] *Gilly,* Case C-336/96, para. 24 and 30 and *Saint-Gobain,* Case C-307/97, para. 56. In the *Gilly* case, the Court examined whether a criterion of nationality used for allocating taxing powers between Member States was contrary to Community law. The Court found this not to be the case. The Court concluded that the way in which the distributive rules allocated taxing powers was not itself the source of disadvantageous tax treatment, but the level of taxation in the contracting states, which remains to be decided by the Member States themselves. See *Gilly,* Case C-336/96, para. 34.

[1166] This term is suggested by Vogel et al. (1997) 27.

[1167] See Ståhl – Österman (2000) 137; Jiménez (1999) 244. In *Gilly,* Case C-336/96, para. 31-32, the Court refers to 'the paying state principle' and 'the criterion of nationality' as being also parts of the OECD Model Convention and therefore as constituting international practice on which it is not unreasonable for the Member States to rely when drafting tax treaties. For more detailed observations on *Gilly,* see van den Hurk (1999) 211-218; Vogel (1998).

incompatibility with Community law.[1168] When exercising their powers of taxation, it is obvious that Member States must act in accordance with Community law.[1169] As a consequence, tax treaty provisions are subject to the same scrutiny by the ECJ, concerning their compatibility with Community law, as are domestic tax measures[1170], though there is a case for making a distinction between distributive rules and method articles, on the one hand, and other treaty provisions, on the other.[1171]

In the *Gilly* case, the Court also examined whether the tax credit mechanism, as provided for by the relevant tax treaty, was compatible with Community law. According to the Court's view, the credit method at issue was based on the so-called ordinary credit method, and followed the arrangements set out by the OECD Model Convention, though it is arguable that this was a somewhat incorrect interpretation.[1172] In any event, under the elimination method, a part of double taxation was not eliminated, owing to the differences in the tax scales between the Member States of employment and residence, the determination of which belongs to the Member States. Therefore, the Court found that the tax credit mechanism at issue was not incompatible with Community law. In particular, the Court delivered the following statements[1173]:

> "[The] object of [a tax treaty] is simply to prevent the same income from being taxed in each of the two States. It is not to ensure that the tax to which the taxpayer is subject in one State

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[1168] See Kemmeren (1998a) 21, who argues that the Court's decision in *Gilly* could have been different if double taxation had not been eliminated by the tax treaty. In the *Gilly* case, the double taxation was eliminated, though arguably not wholly due to the differences in tax rates between the source and residence state. However, the Court held that the application of a tax credit mechanism is not contrary to Community law (see below discussion). See *Gilly,* Case C-336/96, para 40 ff. For criticism, see Vogel (1998) 150. Also Pistone (2002) 260 remarks that the main purpose of Community law is not to allocate taxing powers between two states, but rather to create unconditional rights on persons as such.

[1169] *Saint-Gobain,* Case C-307/97, para. 57.

[1170] See Lang (1996) 17.

[1171] See Ståhl – Österman (2000) 138.

[1172] See *Gilly,* Case C-336/96, para. 41-42. The Court does not expressly refer to the ordinary credit method, but based on the Court's description of the functioning of the credit method at issue it is clear that this was meant by the Court. Nonetheless, it is clear that the credit method used in the Germany-France tax treaty at issue in *Gilly* was not actually based on the ordinary credit method but rather on a modified exemption. See Vogel et al. (1997) 1192. Under the tax treaty, the tax creditable in France was not the German tax but the tax which corresponds to the French tax on the German income as determined on the basis of the total taxable income (i.e. French- and German-source) in France. See Avery Jones (1999) 2-3. In effect, therefore no tax was payable in France on the German income, but the latter was taken into account by way of progression when determining the tax on the French income.

[1173] Even if the Court's understanding in respect of the tax credit mechanism seems somewhat incorrect, its statements in respect of the general compatibility of such mechanisms with Community law remain valid.

> is no higher than that to which he or she would be subject in the other."[1174]
>
> "[It] is common ground that any unfavorable consequences entailed in the present case by the tax credit mechanism set up by the bilateral convention[…]are the result in the first place of the differences between the tax scales of the Member States concerned."[1175]
>
> "[I]f the State of residence were required to accord a tax credit greater than the fraction of its national tax corresponding to the income from abroad, it would have to reduce its tax in respect of the remaining income, which would entail a loss of tax revenue for it and would thus be such as to encroach on its sovereignty in matters of direct taxation."[1176]

As a consequence, it seems that the tax credit method, as laid down in the OECD Model Convention, is generally compatible with Community law, despite the fact that double taxation of income may not always be totally eliminated.[1177] Another point is that the allocation of tax benefits between the source state and residence state also has an impact on the outcome.[1178] However, this issue is not, as a rule, dealt with by tax treaties but is a matter of national tax law.

The *Saint-Gobain* case raises several issues concerning the compatibility of tax treaties with Community law. In contrast to the *Gilly* case, the *Saint-Gobain* case demonstrates that there are fundamental conflicts between the principles of Community law and the international practices adopted in the OECD Model Convention, in particular when it comes to the eligibility of a person for tax treaty benefits. In *Saint-Gobain,* the Court held that a Member State was obliged, under the principle of non-discrimantion, to grant tax treaty benefits to a permanent establishment of a non-resident company established in another Member State, under the same conditions as to resident

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[1174] *Gilly,* Case C-336/96, para. 46.
[1175] *Gilly,* Case C-336/96, para. 47.
[1176] *Gilly,* Case C-336/96, para. 48.
[1177] See van den Hurk (1999) 218. Terra – Wattel (2001) 61 note that according to the *Gilly* case Member States remain competent to determine the mode and method of double taxation relief. Arguments have also been raised against drawing too direct conclusions on the compatibility of tax credit mechanisms with Community law in all cases. See for these Vapaavuori (2003) 292-293. See also Vogel (2002) 9-10, who seems to consider that, even if the credit method were restrictive, as it is in his opinion, it is not likely that the Court would, at least in the short run, condemn the credit method as breaching Community law. Vapaavuori (1998a) 266, also refers to the possibility that, through cooperation between Member States, the insufficiencies related to the application of the tax credit system could be abolished. In this way, the conflict of the tax credit system with Community law could be avoided.
[1178] In fact, the Court also referred to the fact that the taxpayer in question was entitled to personal deductions in the Member State of residence. However, it is arguable that part of the deductions was absorbed by the tax credit mechanism, so that the taxpayer was actually worse-off than if she had not worked in another Member State. See Vogel (1998) 150.

companies.[1179] However, in line with the OECD Model Convention, a tax treaty is applicable only when a person is a resident of a contracting state for tax treaty purposes. The OECD Model Convention, however, does not itself provide an autonomous concept of residence – rather contracting states rely on their national tax laws in this respect. Broadly speaking, the prevailing practice is that only a person who is subject to unlimited tax liability in the contracting state is considered to be a resident for tax treaty purposes. Based on the *Saint-Gobain* case, it becomes clear that the concept of residence for tax treaty purposes conflicts with Community law in that it is too narrow[1180]. It does not cover all persons which are, under Community law, entitled to benefits under the tax treaty network of the involved Member State, in the same way as those who traditionally qualify as residents for tax treaty purposes.[1181] Obviously, permanent establishments are the most prominent, but not necessary the only, example of situations where the definition of residence for tax treaty purposes fails to comply with Community law requirements.[1182] By the same token, the compatibility with Community law of tax treaty provisions aimed at limiting the benefits conferred by tax treaties may be in doubt.[1183] However, there is so far no case law dealing with the compatibility with Community law of various limitation-of-benefits provisions inserted in tax treaties concluded by the Member States.

Finally, it may be noted that, in the *AMID* case of 2000, the Court refused to rule whether national tax rules applied in the Member State were in conflict with the relevant tax treaty concluded by the Member State.[1184] The Court stated that it has no jurisdiction under Article 234 EC to rule on the interpretation of provisions other than those of Community law.[1185] However,

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[1179] Prior to the *Saint-Gobain* judgment, this was deduced by Jann (1996b) 171. For a more thorough discussion, see Jann (1996a) 35 ff. The national treatment requirement applies of course only when the permanent establishment is in a comparable situation with resident companies. See also Jiménez et al. (2001) 243.

[1180] See van den Hurk (2001) 155.

[1181] See Pistone (2002) 165.

[1182] It may be possible to point out also other interpretations of a residence provision leading to incompatibilities with Community law. For an example of a possibly EC-incompatible interpretation of the concept of residence for tax treaty purposes, see Kemmeren (1998b) 126-129. The example involves a dual resident resident company incorporated in the Member State with an effective management in another Member State. Under certain conditions, the Member State of incorporation would refuse, for purposes of its tax treaty concluded with another state (not being the state in which the company has its effective place of management), to issue a certificate of residence for the company owing to its having its effective management in another Member State. Note that Kemmeren discusses the issue in view of the freedom of establishment and freedom to provide services. He also notes that the compatibility is likely to depend on whether there is a valid business reason for the company moving its effective place of management into another Member State. If not, the company might not be protected by fundamental freedoms.

[1183] See also Hinnekens (1994) 158.

[1184] This issue was raised by the Commission rather than by the referring court.

[1185] *AMID,* Case C-141/99, para. 18.

where the same provision or term is used for Community law and tax treaty purposes, the case law of the ECJ may also indirectly affect the interpretation of tax treaty provisions or terms.

7.4 Tax Treatment of Non-Resident Investment Funds in Source State of Income

7.4.1 Issue – Withholding Taxes at Source

The first issue relating to the compatibility with Community law of the taxation of investment fund investments is the different treatment of domestic and foreign investment funds in the source state of income. While investment funds established under the respective investment fund laws of a Member State are typically exempted from income taxation, such an exemption is not extended to non-resident investment funds. As explained earlier in this study, the aim of such exemption is to avoid economic double taxation of income, i.e. the taxation of the same income first at the fund level and subsequently in the hands of underlying investors. However, Member States traditionally do not pay attention to economic double taxation of income in the hands of non-resident investors which are not subject to unlimited tax liability in the Member State. Therefore, tax exemptions provided for, under national laws of Member States, to resident investment funds are not extended to non-resident investment funds established in other Member States. Although it is a well-established practice in the field of international tax law to restrict a general tax exemption to resident investment funds, such practice may be problematic from a Community law point of view.

From the single market perspective, the prevailing variable tax treatment of domestic and foreign investment funds is in doubt. The pre-tax return on investment being equal, an investment fund would have the incentive of investing in domestic securities, the income from which is exempted from tax, rather than in comparable foreign securities, the income from which is subject to (uncreditable) withholding tax in the source state of income. The exemption from taxes only of domestic investment funds seems to impede both inbound and outbound cross-border investments by investment funds into other Member States. In the first place, there is an adverse impact on outbound investments by resident investment funds, as a result of the unequal treatment of resident and non-resident investment funds in the source state of income (home-state restriction). Secondly, from the perspective of a potential source state (target state of investment), there may be a dissuasive effect on the willingness of the non-resident investment funds to invest into assets situated

in the state, provided that asset prices highlight the difference in tax treatment between resident and non-resident investment funds (host-state restriction).[1186]

The issue of different treatment in a Member State arises only insofar as resident investment funds are exempted from tax on an item of income, while the same item of income, when received by non-resident investment funds, is subject to a withholding tax at source. The following table shows the possible sources of unequal treatment in the four Member States covered by this study, sorted by different types of income.

Table 12. Taxation of a resident investment fund as compared to non-resident investment funds.

	Resident fund			Non-resident fund[1187]		
State	DIV	INT	CG	DIV	INT	CG
UK	-	(20%)[1188]	-	-	-	-
GER	-	-	-	(20 %)	-	-
FRA	-	-	-	(25 %)	-	-
FIN	-	-	-	(29 %)	-	-

(X) = tax liability, – = no tax liability

The issue of the different tax treatment of resident and non-resident investment funds in the source state of income is restricted to dividend income; this is subject to withholding tax in three jurisdictions which at the same time exempt resident investment funds from taxation. In Germany, dividend income is subject to a withholding tax of 20 per cent when received by a non-resident investment fund, but no tax is levied – or if levied, it is refundable on request – on such income when paid to resident investment funds. The same applies to dividend income received in France and Finland, where resident investment funds enjoy a comprehensive tax exemption, whereas non-resident investment funds are subject to withholding tax on dividends. As far as other types of income are concerned, there appears to be no difference in the tax treatment owing to the absence of any withholding tax at source. In the United Kingdom, interest paid to domestic investment funds, with the exception of bond funds, is subject to corporation tax, whereas interest income paid to non-resident funds would not be subject to withholding tax.

[1186] This would result from the fact that resident investment funds are willing to pay a higher price for a given security than non-resident investment funds, because the latter must take into account the impact of withholding tax on the post-tax return on investment.
[1187] Tax liability under domestic tax law without regard to tax treaties.
[1188] The tax is levied on the net amount of interest income. In the case of a bond fund, no tax liability.

A withholding tax on dividend at source may be reduced under an applicable tax treaty. Typically, the tax rate would be reduced to 15 per cent, and in some cases may be totally abolished. However as explained in Chapter 4 of this study, the access to tax treaty benefits by an investment fund depends crucially on the assessment by source state tax authorities. While the Finnish approach in conferring tax treaty benefits on investment funds is liberal, the same cannot necessarily be said of the German and French approach. At any rate, the difference in tax treatment of resident and non-resident investment funds in the source state of income will be removed only to the extent that the applicable tax treaty allocates the taxing right, in full, to the residence state of an investment fund. Since the prevalent practice with respect to dividends on portfolio investments is to share the taxing right between the source state and residence state, there remain, even in the case of tax treaty access, substantial differences in tax treatment between resident and non-resident investment funds.

Finally, to complete the picture, the role of the residence state of an investment fund must be briefly considered. In accordance with the principles of international tax law, the residence state is in a position to co-ordinate the taxation of persons fiscally resident in its territory. However, as shown in Chapters 3 and 4 of this study, it is unlikely that an investment fund would be entitled to any kind of tax credit in respect of foreign taxes paid in the source state of income. This would be otherwise only if an investment fund is liable to tax in its residence state, so that there is tax liability against which tax credit may be given. Of the countries covered by this study, this is the case only in the United Kingdom. Therefore, taxes levied on income in the source state remain definitive, at least as far as only the taxation at the investment fund level is considered, without regard to the investor level taxation.[1189]

7.4.2 Assessment under Community Law

Investments made by investment funds in other Member States give rise to capital movements within the meaning of Article 56 EC. According to Article 56 EC, all restrictions on capital movements between Member States are prohibited unless such restrictions are covered by the exceptions provided for in Article 58 EC or otherwise justified under the rule of reason test. It is indisputable that foreign investment funds are discouraged from investing in securities, the income on which is subject to withholding tax in the Member State only when it is received by foreign investment funds, in contrast to

[1189] The role of the residence state of an investor will be considered in greater detail in Chapter 7.5.

domestic investment funds which are exempted from taxes. Here an interesting parallel may be drawn also with non-profit organizations: these are often exempted from taxes in their residence state, whereas Member States do not extend such an exemption to non-profit organizations established outside the Member State.[1190] It is notable that of late the Commission has taken into consideration the compatibility with Community law of different treatment of non-profit organizations depending on their place of establishment.[1191]

The next question is whether the obstacle to capital movements arising from the different treatment of domestic and foreign investment funds could be covered by one of the exceptions laid down in Article 58 EC, or could otherwise be justified under the rule of reason test. Several possible arguments seem relevant in the matter.

In the first place, the Member State involved might argue that the situations of domestic and foreign investment funds are not comparable, and that therefore the different treatment should be justified under Article 58(1)(a) EC. In the second place, the Member State involved might rely on the cohesion of its tax system.

As regards Article 58(1)(a) EC in conjunction with Article 58(3) EC, and with a view to establishing whether the different treatment of domestic and foreign investment funds in the residence state constitutes prohibited discrimination, there must be examination of whether the situations of the two categories of investment funds are comparable. It follows from the Court's case law that the situations of resident and non-resident entities are generally comparable, unless an objective difference between the entities is proved to exist. It is submitted here that there is no objective difference between the domestic and foreign investment funds, to the extent that the former are comprehensively exempted from taxes on income in the Member State. In the absence of an objective difference, a withholding tax, imposed by a Member State on a dividend paid to a non-resident investment fund established in another Member State, would be regarded as a discriminatory tax measure which in no case can be justified under Article 58(1)(a) EC.

At a more general level, one might also argue that a distinction between domestic and foreign investment funds, to the extent that these qualify as UCITS, is doubtful in view of the fact that, for the most part, legislations governing such entities are harmonized by secondary Community law, that is by the UCITS Directive. Although the harmonization does not concern the direct tax treatment of investment funds, discrimination or restrictions caused by national tax measures are clearly at odds with the objectives of the UCITS

[1190] See Bater (1999) 453 and 460-461.

[1191] See Eicker (2003).

Directive – to approximate the conditions of competition and to bring about a single capital market within the Community. The different treatment of domestic UCITS and foreign UCITS also seems to conflict with the principle of mutual recognition, which is one of the cornerstones of the UCITS Directive. Most national tax laws confer the exemption from taxes only on those investment funds which comply with the investment fund laws of the Member State. Owing to the fact that such laws are to a large extent harmonized between the Member States by the UCITS Directive, it is difficult to see any obvious reason why foreign UCITS should be treated differently.

Bearing in mind the rationale behind the exemption of resident investment funds from income taxes – that is, the prevention of economic double taxation of income – it seems likely that the cohesion of the tax system would take priority among the possible grounds of justification under the rule of reason.[1192] It could be argued by Member States that the cohesion of the tax system requires that the exemption of withholding taxes should not be extended to non-resident investment funds, since the investors of such funds, in contrast to those of resident investment funds, are generally not taxable on their income in the source state of income. Hence there is no economic double taxation to be compensated for in the case of foreign investment funds. This line of reasoning would essentially correspond to the justification grounds submitted by the involved Member State in the cases *Baars* and *Verkooijen*. Moreover, the OECD Model Convention does not require the prevention of economic double taxation.

However, from the perspective of Community law, the argument based on the cohesion of the tax system will end up in insurmountable difficulties. In the first place, it may be noted that the argument, that there is no economic double taxation to be compensated for in the case of non-resident investment funds, is disputable. In a case where there are resident investors participating in the non-resident investment fund, deriving income liable to withholding tax from the Member State, there *will* be some economic double taxation to be compensated for in that Member State.[1193] Owing to the fact that economic double taxation is nonetheless not mitigated at the resident investor level, in respect of the income derived from the Member State, but that income is subject to tax in the same way as income received through a domestic

[1192] Based on the Court's case law, it seems that the treaty-based grounds of justification do not necessarily take priority over the rule of reason justifications. In the case *Commission v. Belgium,* the ECJ has considered first the Member State's justification based on the coherence of the tax system before turning to justification on grounds of Art. 58(1)(b) EC. See *Commission v. Belgium,* Case C-478/98, para. 33 ff.

[1193] This holds true at least as far as neither the non-resident investment fund nor the resident investor is granted tax credit for the levied withholding taxes in other Member States.

investment fund, it is difficult to rely on the coherence of the tax system as a ground of justification.[1194]

The more obvious counterargument is that, in the eyes of the ECJ, there is no direct link between the exemption of an investment fund from taxes, and the income tax payable by an underlying investor on the same income. Moreover, arguably two different taxpayers are involved, unless the transparency of an investment fund is appreciated by the Court. Both are factors which are liable to qualify the existing link as merely indirect in nature, and to make the argument based on the cohesion of the tax system invalid in the eyes of the Court. For the sake of clarity, it may also be noted that the reduction in tax revenue, arising from the exemption of non-resident investment funds from withholding taxes, is not capable of justifying the different treatment; this reduction is often closely linked to the cohesion argument.[1195]

Yet another possible argument for the Member State involved might be that, on account of possible tax treaty access, and subject to the details of an applicable treaty provision, a foreign investment fund will not, in practice, be liable to higher taxes than domestic investment funds (in case a tax treaty provides nil rate of tax); or that the disadvantage caused by domestic tax law is partly mitigated by the applicable tax treaty (in case a tax treaty provides a rate higher than nil). However, nor would this argument be successful before the ECJ. Already in the *Avoir fiscal* case, the Court clearly stated that the rights conferred by fundamental freedom provisions are unconditional and cannot be made subject to provisions of tax treaties.[1196] In any case, in view of the uncertainty regarding the tax treaty access of investment funds and the variety of treaty provisions, a breach of Community law cannot generally be removed by way of a tax treaty.

An even more remote possibility would be that the Court would accept an argument that a discriminatory or restrictive treatment of a foreign investment fund, arising from the imposition of withholding taxes, could be compensated by a credit for such taxes in the residence state of an investor. In the first place, this follows from the Court's general approach of not looking into the overall tax position of an unfavorably treated taxpayer, and from the settled case law that disadvantageous tax treatment in another Member State cannot be justified by other tax advantages enjoyed by the taxpayer in the residence state. Secondly, in line with the Court's case law regarding the cohesion of the tax

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[1194] In fact, as was seen in Chapter 5 of this study, a resident investor receiving dividend income from his own Member State through a non-resident investment fund will in most cases be worse-off than if he had used a resident investment fund as a means of investment.

[1195] See *Verkooijen,* Case C-35/98, para. 52 and 59.

[1196] See *Avoir fiscal*, Case 270/83, para. 26.

system, it seems unlikely that it would see any connection at all – between the withholding tax imposed on an investment fund, and the income tax paid by the investor on income received from the investment fund – which would allow the argument at hand.

Conclusion. In conclusion of the above discussion, it is submitted that Community law, in particular Article 56 EC, prevents a Member State from applying a withholding tax on income paid to a foreign investment fund established in another Member State if, at the same time, domestic investment funds are exempted from taxes.[1197]

7.5 Tax Treatment of Resident Investors of Foreign Investment Funds

7.5.1 Issue 1 – Tax Benefits

The applicable tax rules on investment fund investments may differ in the residence state of an investor, depending on whether the investor has made an investment in a resident or in a non-resident investment fund. While some Member States apply a different set of tax rules to investment fund investments, depending on whether an investor participates in a domestic or foreign investment fund, other Member States do not distinguish in this respect in their tax laws. At the one extreme, prior to the legislative changes of 2004, Germany had separate sets of comprehensive tax rules for investors in domestic and foreign investment fund investments respectively. At the other extreme, Finland does not distinguish, for tax purposes relating to investors, between domestic and foreign investment funds so that both are, as a rule, taxed in accordance with the same principles. As of 2004, the taxation of income from investment funds in Germany is governed by a single set of rules applicable both to the domestic and foreign investment fund investments. On the other hand, France has enacted comprehensive tax rules only for investments in domestic investment funds, whereas investments in foreign investment funds have been left to be dealt with in accordance with taxing principles generally applied to income received based on foreign securities. The approach of the United Kingdom is characterized by the offshore funds legislation, applicable only to cross-border fund investments.

[1197] In Chapter 8.3.2.1 another possibility of enhancing integration, namely positive Community measures as regards the abolition of withholding taxes at source in respect of income received by foreign investment funds, will be discussed. In that context, broader consequences of abolishing withholding taxes in respect of income received by foreign investment funds from the perspective of a single market are also discussed.

As noted in the evaluation sections of the previous chapter of the study, several differences in the tax treatment, as between resident investors of domestic and of foreign investment funds, can be found. In most cases, national tax laws place investors in foreign investment funds at a disadvantageous position, by not extending certain tax benefits – available in the context of domestic investment funds – to such investors. The different treatment, resulting from the non-applicability of certain preferential tax rules to resident investors of foreign investment funds, is typically systematic in that it cannot be avoided by either the foreign fund or its investor. Apart from that, there are differences in tax treatment deriving from certain special tax measures targeted at foreign investment fund investments. Such tax measures typically take the form of anti-avoidance legislation, with a view to ensuring the compliance of both the foreign investment fund and its resident investors with tax laws of the Member State. Unlike in the case of systematic differences, unfavorable tax treatment deriving from such legislation is generally avoidable, by way of the investment fund or its investors complying with the requirements set out therein. The discussion below concerns itself with the issue of tax benefits (Issue I), whereas the issue of anti-avoidance legislation is dealt with in the subsequent sections (Issue II).

With regard to tax benefits, a further distinction seems proper. In the first place, there are tax benefits attached to a certain item of income under the general tax regime of a Member State (Issue Ia). It is notable that such tax benefits are often confined to *domestic-source* income, in contrast to foreign-source income, irrespective of whether received directly or through an investment fund. Several examples of benefits of this kind were pointed out in the evaluation sections of this study. In the United Kingdom, an imputation credit of 1/9 is generally attached to domestic dividends. As a result, only a resident investor in a UK investment fund is entitled to a tax credit related to a dividend distribution by the fund, whereas distributions from foreign companies, including investment funds, do not entitle a resident investor to such a credit.[1198] In France, there is an allowance of €1220 (or €2440 for jointly-taxed spouses) only on French-source dividends, as well as an *avoir fiscal* related only to French-source dividends. While such benefits are available in a case where qualifying income is received through domestic investment funds, they are not extended to qualifying income received through foreign investment funds. This is the consequence of France's not having extended the principle of transparency to foreign investment funds but rather treating them as intransparent foreign companies with no income flow-through.

[1198] In that regard, it must also be mentioned that the United Kingdom does not extend the credit to non-resident investors of UK investment funds. This issue will be dealt with in Chapter 7.6.

Until 2004, Germany had expressly excluded dividends, whether domestic- or foreign-source, received through foreign investment funds from the half-income system, whereas dividends received via domestic funds, and directly, were covered by the system. However, as of 2004, the difference in treatment has been repealed.

Another category of tax benefits consists of tax credits in respect of foreign withholding taxes levied on income when paid to an investment fund (Issue Ib). It is the practice of France to allow a credit for foreign withholding taxes at the investor level only in the case of investments in French funds. This also is the consequence of France's not extending the principle of transparency to foreign investment funds. Until 2004, Germany did allow credit for withholding taxes exclusively for investors of domestic investment funds. However, as of 2004, the difference in treatment has been repealed.

There are several national policy reasons for Member States not to extend the benefits to foreign investment fund investments. France has opted not to treat foreign investment funds as transparent on account of administrative concerns related to dealing with such an approach in practice. Germany originally excluded dividends from foreign investment funds from the half-income system on the cumbersome ground that the overall abolition of imputation credit system had no adverse impact on foreign investment funds, because these, in contrast to German investment funds, were not in any case entitled to imputation credit with respect to German-source dividends. Hence, the explanation went, there was no need for compensation which would necessitate the extension of the half-income system to dividends received through such entities.[1199] However, it was also claimed that, by excluding dividends from foreign investment funds from the half-income system, the German legislator attempted outright discouragement of investments in such entities.[1200]

7.5.2 Assessment under Community Law

There are clearly two different perspectives from which the compatibility with Community law of national tax measures distinguishing between resident investors in domestic and foreign investment funds can be considered. On the one hand, from the perspective of an investor, an investment in a foreign investment fund is covered by Article 56 EC enshrining the free movement of

[1199] See Tibo (2000) 2293.

[1200] See Tibo (2000) 2293-2294; Rädler (2002) 623. Cf. Roth (2001) 209, who considers the disadvantage caused by the exclusion be "negligible". Clearly, such argument would not be successful before the ECJ.

capital. As discussed, it prohibits restrictions set by the residence state of an investor on outbound investments into other Member States.

On the other hand, from the perspective of an investment fund or its promoter, as the case may be, the distribution of units in another Member State constitutes a provision of service which is, in principle, covered by Article 49 EC prohibiting restrictions on freedom to provide services. Strictly speaking, however, cross-border distribution of units is primarily covered by Article 56 EC, in accordance with the Nomenclature of 1988 Directive and the priority of Article 56 EC over Article 49 EC. However, from an economic substance point of view, and in view of the fact that the Court has shown a liberal approach towards considering simultaneously both the provisions concerning capital and services, it is proper to consider the matter also from the point of view of freedom to provide services. In that regard, as the case law of the ECJ shows, Article 49 EC applies also to measures which indirectly discourage investors of a Member State from acquiring services from a provider established in another Member State.

Issue Ia. The first matter to be considered is the admissibility of confining certain tax benefits – often concerning, more or less, the elimination or alleviation of economic double taxation of income – to resident investors investing in domestic funds. Here reference can be made to the Court's case law involving national provisions aimed at providing relief from double taxation of income, but which are confined to income received from domestic sources (*Verkooijen*), assets located in the domestic territory (*Baars*) or resident investors (*Avoir fiscal*).

A parallel case may be drawn to imputation tax systems applied by some Member States in respect of dividend income received from companies. As a rule, imputation tax systems are confined to domestic situations, in the sense that an imputation credit is granted only to resident investors, and only in respect of dividends received from a resident company subject to corporate tax. As to the compatibility of imputation systems with Community law, there is so far no ruling by the ECJ concerning the issue. However, the Finnish Supreme Administrative Court has requested a preliminary ruling from the Court on the EC-compatibility of the Finnish imputation tax system.[1201] More specifically, the question under scrutiny is whether Finland is, under Community law, obliged to extend imputation credits even to dividends from non-resident companies received by Finnish shareholders.[1202] In legal literature, the

[1201] The request was submitted in *Manninen*, Case C-319/02, on 10 September 2002 by the Supreme Administrative Court. Advocate General Juliane Kokott delivered her Opinion on 18 March 2004. The judgment by the ECJ is expected in the second half of 2004.

[1202] See KHO 2002:56, para. 3.5. For details of the Finnish imputation system, see Liede – Hintsanen (2003) 31-32; Andersson (2001) 128 ff.; Juusela (2001b) 481-483.

prevailing opinion seems to be that imputation credit systems are generally liable to result in a breach of Community law, in that they constitute a restriction on Article 56 EC, by treating domestic-source dividends more favorably than foreign-source dividends in the hands of resident investors[1203], unless a justification for the different treatment can be found under the rule of reason test.

The same line of reasoning is applicable to tax benefits under consideration here. As was shown in the evaluation sections concerning the United Kingdom and France, the practices of confining benefits, as a rule, result in a more favorable tax treatment of income from domestic investment funds as compared to foreign investment funds in the hands of resident investors.[1204] Thus, as with imputation tax systems, the United Kingdom and France discourage resident investors from investing in foreign investment funds, by treating income from domestic investment funds more favorably for tax purposes. This constitutes an obstacle to the free movement of capital under Article 56 EC, and to the freedom to provide services under Article 49 EC. As regards the tax allowance on domestic dividends in France, the Commission has also recently issued a formal request for information, in light of the fact that such allowance may constitute a breach of Articles 49 and 56 EC.[1205]

Under the exception provided for in Article 58(1)(a) EC, a Member State may distinguish, for tax purposes, between taxpayers who are not in the same situation with regard to the place where their capital is invested. However, under Article 58(3) EC different tax treatment shall not constitute prohibited discrimination. It is settled case law that the different treatment of taxpayers who are in a comparable situation constitutes discrimination. The line of case law of the Court concerning cross-border investments by individuals shows that, whereas there may be objective differences between resident and non-resident persons in certain cases, this is not generally the case between resident investors. In *Baars,* the Court took the comparability of the situations between residents for granted, irrespective of the different place of invested capital.[1206] The same was true in *Verkooijen*.[1207] In both the cases, both the

[1203] See, for example, Vapaavuori (2003) 307; Liede – Hintsanen (2003) 32-33; Richter (2002) 731; Lupo (2000) 270; Gustafsson (2000) 676; Lodin (1999) 218. This view is also shared by the Advocate General in her opinion. See para. 27-33 of the Opinion of Advocate General Kokott.

[1204] See also, for the United Kingdom, FEFSI & PricewaterhouseCoopers (2001a) 29-30, and for France, FEFSI & PricewaterhouseCoopers (2001a) 18-19; Gouthière (2000) 47.

[1205] See EC Update, *European Taxation,* September 2003, EC-29. In this context, the Commission also referred to the violation of the UCITS Directive.

[1206] The *Baars* case was decided based on the provision concerning freedom of establishment. Nonetheless, the Advocate General in his opinion also deals with Articles 56 and 58 EC concerning free movement of capital. In the Advocate General's view, the confining of an exemption from net wealth taxes only in respect of share holdings in resident companies constitutes arbitrary discrimination which cannot be saved by Article 58(1)(a) EC. However, the Advocate General does

categories of resident investors were engaged in the same economic activity (*Baars:* holding shares, *Verkooijen:* recipient of dividend) and were taxed according to the same tax rules (*Baars:* liability to wealth tax in respect of share holding, *Verkooijen*: dividends subject to tax).[1208] As a result, it is safe to assume that resident UK fund investors, or resident French fund investors, respectively, are in a comparable situation, irrespective of whether they invest in domestic or foreign investment funds, since there is no substantial difference as regards economic activity or the liability to tax on the income received based on investments. Therefore, the difference in treatment at issue cannot fall within the exception as provided for by Article 58(1)(a) EC.

As for a potential justification ground, a parallel may again be drawn to the case of imputation tax systems. The argument based on the coherence of the tax system has often been put forward as the most plausible candidate to save imputation tax systems.[1209] The Finnish government, too, has relied on the coherence argument as a possible justification for the different treatment of domestic- and foreign-source dividends under the imputation tax system. In line with the Court's reasoning in the *Bachmann* case, it contends that, since the imputation credit is granted only if Finnish resident companies have been taxed on the same income in Finland and because foreign distributing companies are not subject to tax in Finland, the coherence of the Finnish tax system requires a different treatment of dividends in the two cases. However, it is arguable that the Court will not accept the coherence argument to save the Finnish imputation system.[1210] This results from the fact that there are two different taxes (corporate tax/income tax) and two different taxpayers involved (company/shareholder) in which case there generally is no direct link as required by the ECJ between the imputation credit and the taxation of the distributing company[1211].[1212] As a result, the argument that the imputation

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not deal expressly with the comparability of the situations of the resident taxpayers. See Opinion of Advocate General Alber, *Baars,* Case C-251/98, para. 51 ff.

[1207] The Court did not deal expressly with the comparability issue. See also Pistone (2002) 160, who states: "[…]when applying a restriction-based approach, the Court does not normally require a strict comparison, so that Dutch recipients of dividends distributed by Dutch companies and Dutch recipients of dividends from non-Dutch companies could be at least regarded in a substantially similar situation."

[1208] See also van Thiel (2001) 468, who states: "in most cases concerning a comparison between two residents, similarity can be assumed if [residents] are engaged in the same economic activity and taxed according to the same rules."

[1209] The coherence argument was raised in the cases *Metallgesellschaft & Hoechst, Baars* and *Verkooijen*, which all involved a scrutiny of measures broadly comparable to imputation tax systems.

[1210] See Liede – Hintsanen (2003) 35.

[1211] Sometimes it has been pointed out that in the systems based on *avoir fiscal* the link between the imputation credit and taxation of the underlying company is of a more direct nature than in the case of exemption systems. See Gustafsson (2000) 679. However, this is not likely to make any difference as there still are two different taxes levied on two different taxpayers involved.

[1212] It has also been argued that Finland cannot invoke the coherence defence due to the fact that under the Finland-Ireland tax treaty an Irish investor in a Finnish company may, under certain conditions, be

credit can be denied in respect of foreign-source dividends, on grounds that the latter are paid out of profits which have not been subject to domestic corporate tax is out of question.[1213] Rather, it is arguable that, in order for the imputation system to be compatible with Community law, either foreign dividends must be treated equally to domestic dividends ('national treatment of foreign dividends'), or at least foreign corporation taxes paid by the non-resident distributing company must be recognized as creditable, along the same line as domestic corporation tax, for the purposes of the imputation system ('mutual recognition of corporation tax').[1214] In any case, Finland decided recently to abolish its imputation credit system as of 2005[1215], rather than extending the system to cross-border situations.

As regards the coherence of the tax system in the context of the subject of this study, the starting point seems to be comparable to the case of imputation tax systems. In the case of French *avoir fiscal* and tax allowance, there are two different taxes levied (corporate tax/income tax) on two separate taxpayers (French company/French investor), in which case the coherence of the tax system cannot be invoked. Moreover, with regard to the tax allowance on French-source dividends, a direct parallel to the *Verkooijen* case and the failure of the cohesion argument may be drawn.

At first sight, the same seems to apply to the UK tax regime, since there are two different taxes (corporate tax/income tax) on two separate taxpayers (UK fund/UK investor). However, in view of the UK tax system, a significant difference between the case of a UK investment fund and a foreign investment fund may be pointed out: while the foreign companies are, as a rule, subject to tax in the state of residence, this is not the case for foreign investment funds, which are often exempted from corporate taxes in the residence state. Should

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entitled to receive half of the imputation credit that a Finnish taxpayer would receive. Therefore, Finland would have given up its national coherence with respect to the imputation tax system. See Liede – Hintsanen (2003) 35. However, this may also be seen differently. It may be said that Finland has not totally given up its coherence, in the sense that even in a case where the credit is extended to Irish investors, there still remains the link between conferring the credit and the taxation of the Finnish company. However, the coherence is lost in the sense that Finland could no longer argue that the credit is not extended to *non-resident* investors in Finnish companies on grounds that the dividend cannot subsequently be taxed in Finland, because it has by way of a tax treaty conferred the credit on Irish investors which are not subject to tax in Finland.

[1213] Terra – Wattel (2001) 73. See also Lupo (2000) 274.

[1214] See Terra – Wattel (2001) 73. See also Lupo (2000) 274. According to Advocate General Kokott in *Manninen,* Pending case C-319/02, the coherence argument cannot be sustained if taxes paid by the foreign dividend-distributing company are not taken into account as creditable taxes. See para. 80 of the Opinion of Advocate General.

Yet another theoretical possibility could be to exempt foreign-source dividends from taxation, while continuing the application of the imputation system exclusively to domestic dividends. In such circumstances, there would be room to claim that the situations of resident recipients of foreign-source and domestic-source dividends respectively are not in a comparable situation, owing to the fact that only the latter are taxed on the income.

[1215] See HE 92/2004 and Ministry of Finance (2002) 82.

the United Kingdom be required to extend the credit also to distributions from tax-exempted foreign investment funds, this would generally result in a more favorable taxation of foreign fund distributions. Therefore, an outright equal treatment of fund distributions, irrespective of their origin, seems not to provide a satisfactory result. However, in line with the doctrine of mutual recognition of corporate taxes, it is arguable that, in order to make its regime compatible with Community law, the United Kingdom should extend the credit to distributions received from the foreign investment funds, which are subject to corporate tax on their income in the residence state in the same way as UK investment funds.[1216] In this way, the discriminatory effect with regard to foreign fund investments would, for the most part, be eliminated. Nonetheless, this suggested form for the compatibility of the UK tax regime with Community law is subject to the ECJ recognising the coherence of the tax regime applied by the United Kingdom, which in no way can be considered certain.

From the perspective of a Member State, the extension of benefits to distributions from foreign entities may result in practical problems.[1217] However, it is settled case law that such difficulties of an administrative nature are not accepted by the Court as a justification for failing to extend benefits to cross-border income. Moreover, in the case of the United Kingdom such problems are diminished by the fact that the imputation credit is not strictly linked to the paid corporate tax by an investment fund, because such credit is granted at a flat rate of 1/9 of the net distribution. Consequently, for the purposes of granting credit to a UK investor, it must only be determined whether or not the foreign distributing fund has been subject to tax in its residence state. On the other hand, it must be admitted that in borderline cases, for example, where the fund is nominally subject to tax, but does not always effectively pay tax, difficulties may arise as to whether the credit should be granted or not.[1218] It must also be remembered that the impact of the extension would in any case be fairly insignificant, as most Member States have exempted resident investment funds from taxes.

The extension of benefits to income from foreign investment funds would also result in a decrease of tax revenues for the Member States. However, it is settled case law that reduction in tax revenue cannot serve as a justification for discriminatory or restrictive tax measures.

[1216] Should the tax be lower than the comparable UK corporate tax, the credit could obviously also be proportionally lower.

[1217] Lupo (2000) 275. Such concerns are also discussed in para. 76-79 of the Opinion of the Advocate General Kokott in *Manninen,* Pending case C-319/02.

[1218] For example, the Belgian SICAV is subject to corporation tax but, owing to the limited taxable base, the income received by the fund is not in practice subject to tax. See for the taxation of the Belgian SICAV, Ballon (1997) 295.

In conclusion, it is submitted that the French system of confining the tax allowance and *avoir fiscal* only to domestic-source dividends received through French investment funds is incompatible with Articles 56 and 49 EC. Without regard to the mere fact that such benefits are confined to French-source dividends – which in itself is in conflict with Community law – it is submitted that French investors in foreign investment funds must be eligible for the same tax benefits under the same conditions as French investors in French investment funds. In any case, France recently announced, in the 2004 Finance Bill, that it will abolish the system based on *avoir fiscal* for dividends distributed on or after 1 January 2005.[1219] As a result, the incompatibility caused by the non-extension of *avoir fiscal* to cross-border fund investments will also disappear.

As regards the United Kingdom, a case-by-case analysis is, in principle, needed to establish whether the different treatment of investors in UK investment funds and foreign investment funds respectively, with respect to imputation credit, turns out to be disadvantageous to the latter category. However, should the Court follow its strict interpretation of the comparability of resident investors with domestic and cross-border investments, and continue to recognizing the coherence defense only with respect to the single tax measure as opposed to the tax system, it seems likely that the UK tax regime will be condemned as being in breach of Articles 56 and 49 EC.

Issue Ib. Another issue to be dealt with is the compatibility with Community law of national measures under which withholding taxes, levied at source on income paid to the investment fund, are creditable for underlying investors of the fund. Presently, Germany and France, both jurisdictions traditionally following the principle of transparency, apply such measures. Interestingly enough, recent legislative changes in Germany have brought about fundamental differences between the methods applied by Germany and France respectively. Therefore, it is appropriate first to consider the French system, which for the most part shares similarities with the German system as applied prior to the legislative changes.

Following from the fact that France has carried out the principle of transparency only with respect to domestic investment funds, the credit for foreign withholding taxes is available only for investors of such funds. In contrast, French investors in foreign investment funds are taxed on their income, in the same way as on income on shares in (intransparent) foreign companies. Due to the absence of specific tax rules in France providing for a transparent treatment of such funds, no credit is available in the case of foreign investment funds. As a consequence, the taxation of income which has

[1219] Ernst & Young Worldwide Corporate Tax Guide 2004, 246.

suffered third-country withholding tax, or – as the case may also be – French withholding tax, is, as a rule, taxed more heavily in the hands of a French investor when received through a foreign investment fund, as compared to a French investment fund, in which case a credit is granted against the investor's personal tax liability. This is likely to encourage French investors to hold securities producing income liable to withholding tax through French investment funds rather than through foreign investment funds, which is liable to constitute a restriction on Articles 56 EC and 49 EC, unless justified under the rule of reason. For the same reason as explained above, Article 58(1)(a) EC cannot be invoked to justify the different treatment of French investors.

Prior to the *Investmentsteuergesetz* (InvStG), Germany confined the credit for third-country withholding taxes to resident investors in German investment funds. Under the *Auslandsinvestmentgesetz (*AuslInvestmG*),* it was not generally possible to credit third-country withholding taxes suffered by the foreign investment fund, though there existed the possibility for an indirect tax credit in certain cases. However, under the InvStG, the rules aimed at elimination of double taxation of income received through investment funds are applicable to investors in both German and foreign investment funds. As an alternative for a credit at the investor level, there is also the possibility for a deduction from the taxable income of the investor when calculated at the fund level.

Turning back to the French system, it must be considered whether the exclusion of investors in foreign investment funds from the credit for third-country withholding taxes, or French withholding tax, as the case may be, may be justified. In the first place, it seems that the non-transparency of foreign investment funds – which in effect results in the non-availability of foreign tax credits in the hands of French investors in such funds[1220] – is considered necessary to simplify the enforcement of French tax laws. In terms of the rule of reason test, the argument based on administrative difficulties might therefore be invoked. However, as mentioned earlier, it is clear that the ECJ does not accept justifications related to administrative difficulties under the rule of reason test. Moreover, the example of Germany shows that there are possibilities for the elimination of double taxation in respect also of income received from foreign investment funds. Although the new German system cannot totally avoid the practical difficulties related to the extension of credit to cross-border fund investments, the introduction of an alternative of tax deduction at the fund level, when calculating the taxable income for German

[1220] More specifically, the reason is that French investors of foreign investment funds cannot invoke tax treaties, and therefore the methods of elimination of double taxation, concluded between France and the source state from which the foreign investment fund derives income. As mentioned earlier, for the purpose of individual income tax, there is no unilateral method of elimination of double taxation.

tax purposes, seems a proper and EC-compatible way of dealing with such difficulties. Of course, the impact of a deduction at the fund level is not, as a rule, comparable to that of granting a credit at the investor level, but this is for the most part a matter for investment funds, whether domestic or foreign, to decide for themselves. Obviously, a deduction at the fund level requires fewer administrative burdens, from the perspective of an investment fund, than determining the amount of credit to be allocated to each unit held by German investors.

Another argument for withholding the credit from investors of foreign investment funds might be based on the cohesion of the tax system. However, it is difficult to see any reason why the ECJ would accept the cohesion of the tax system as a justification in this case. There is no reason, from the perspective of coherence, to allow only investors in domestic investment funds to credit foreign withholding taxes, whereas such taxes cannot be credited by investors in foreign investment funds. Both categories of taxpayers are taxable on the income, which, when paid to the investment fund, has been subject to the creditable withholding tax in the same way. Finally, it is settled case law that any budgetary reasons certainly cannot be invoked before the ECJ.

It is submitted that the different treatment of domestic and foreign investment fund investments, with a view to allowing a credit for foreign withholding taxes is in conflict with Community law. This being the case, the possibility of benefiting from foreign tax credits only in the case of domestic investment fund investments, such as that under French laws, must either be abolished, or the benefit must be extended to investments in foreign investment funds. In regard to the latter option, the example of Germany may be considered as a proper alternative to the existing French tax rules.

7.5.3 Issue 2 – Anti-Avoidance Measures

With a view to securing an efficient tax control, and to preventing tax avoidance by resident investors, some Member States impose obligations, concerning tax reporting, on those foreign investment funds which distribute their units to resident investors of the Member State. In addition, they often make the tax treatment of a resident investor in a foreign investment fund dependent on the fund's compliance with the obligations. Of the Member States covered by this study, the United Kingdom and Germany belong to this category of Member States.

In the United Kingdom, the failure to become recognized as a distributing fund, within the meaning of the offshore funds legislation, results in the denial of a more favorable tax treatment of capital gains from disposal of units, by

way of reclassification of capital gains as ordinary income. The offshore funds legislation is by definition applied only to foreign investment funds. Under the offshore funds legislation, a foreign investment fund wishing to avoid harmful tax consequences at the UK investor level must apply for certification with the Inland Revenue. The onus of applying for certification without doubt does constitute an additional burden on foreign investment funds; however, the relative extent of the discouraging effect on offering units to UK investors in a particular case is likely to depend on the size of the investment fund, or on the amount of expected investments derived from the UK market. In case a foreign investment fund does not apply for certification, or does not meet the requirements for certification, harmful tax consequences are assigned to the level of UK investors. In a case where the foreign investment fund fails to apply for certification but fulfils the requirements for becoming a distributing fund, a UK investor may individually apply for an indirect certification, the requirements of which are, however, likely to be too onerous to fulfill in practice. Whichever the case, this is likely to discourage UK investors from placing money into units of foreign investment funds.

As for the case of Germany prior to the legislative changes of 2004, the *Auslandsinvestmentgesetz (*AuslInvestmG) imposed burdensome tax consequences on investors of any foreign investment funds which failed to meet the requirements concerning registration for public distribution, appointment of a tax representantive and disclosure of certain tax relevant information. For the purposes of taxation, the AuslInvestmG distinguished between three categories of foreign investment funds, namely white, grey and black group investment funds. The classification of an investment fund depended on both its registration for public distribution in Germany and the degree of compliance with other duties imposed on the fund. As of 2004, the number of categories of investment funds under *Investmentsteuergesetz* (InvStG) is reduced to two, the only distinction being whether or not the investment fund complies with tax reporting requirements. Therefore, registration for public distribution and the appointment of a tax representative are no longer prerequisites for preferential tax treatment. The most significant novelty is, however, the consolidation of tax reporting requirements and therefore the classification of investment funds for tax purposes between German and foreign investment funds. It is clear that the change was considered necessary to avoid conflicts with Community law.[1221] In this

[1221] However, interestingly enough, prior to Germany's repealing the AuslInvestmG, the Tax Court of Cologne (FG Köln v. 22.8.2001, 14 K 35/99) delivered its judgment on the compatibility with Community law of the tax treatment of German investors in black group funds under the AuslInvestmG. The Tax Court of Cologne found the tax treatment not in violation of Art. 56 EC. On the one hand, it argued that the tax treatment did not put investors of black group funds at a

connection, it may be mentioned that a similar system to that under the AuslInvestmG is still applied in Austria,[1222] doubts having also been expressed on the compatibility with Community law of Austrian laws concerning foreign investment funds.[1223]

Despite the fundamental changes in Germany, the onerous requirements concerning tax reporting are likely to continue to discourage foreign investment funds from marketing their units in Germany. However, in view of the fact that the same rules are applicable to Germany's own investment funds, the examination of their compatibility or incompatibility with Community law has become a more delicate issue.

Moreover, it must be pointed out that, in a case where a foreign investment fund fails to meet the requirements concerning tax reporting, harmful tax consequences are assigned to German investors. This also is likely to discourage German investors from acquiring units in foreign investment funds to the extent that there is a risk that these may not comply with the requirements. However, unlike the case previously, the same harmful tax consequences are also assigned to resident investors in non-complying German investment funds.[1224] In the case of non-complying funds, the taxation of fictitious amounts, as set out in the InvStG, will result in a quasi-penal taxation which would make an investment in an investment fund unprofitable for the investor. As regards the UK offshore funds legislation, the tax disadvantage, if any, caused by the legislation must be examined on a case-by-case basis. However, for Community law purposes, it is generally sufficient to state that the UK offshore funds legislation potentially results in a disadvantageous tax treatment of cross-border fund investments.

Other discouraging effects may also be pointed out. For example, there may remain considerable uncertainty as to the applicable tax treatment at the investor level, on account of the possible degradation of the classification of the fund should the fund cease to meet the requirements set out in law. Unlike in the case of the UK offshore funds legislation, a German investor has probably no possibility by himself of avoiding the harmful tax consequences arising from the fund's non-compliance.[1225]

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disadvantage in the majority of cases. On the other hand, it also found that such treatment can be justified on grounds of effectiveness of fiscal controls.

[1222] See Kirchmayr (2001) 287-288.

[1223] See Polivanova-Rosenauer (2002) 509.

[1224] Under the KAGG, resident investors of German investment funds were taxed by way of an individual assessment in the absence of relevant tax information.

[1225] Under the AuslInvestmG, in the case of a grey group fund, there was a theoretical possibility for an investor to avoid harmful tax consequences by determining and declaring the income of the fund to the German tax authorities.

It is important to understand the rationale behind the anti-avoidance rules applied to foreign investment funds, from the perspective of Member States in their capacity as a host state. In the first place, such rules usually serve the legitimate aim of establishing competitive neutrality between resident investors making investments in domestic and foreign investment funds.

Consequently, the offshore funds legislation enacted by the United Kingdom aims to prevent tax-free accumulation of investment income within foreign investment funds by resident investors, because such accumulation is not, for tax purposes, possible for resident investors in domestic funds. Therefore, its aim is to contribute towards a more neutral tax treatment of domestic and foreign investment fund investments.

In Germany, the repealed AuslInvestmG originally sought to approximate the taxation of foreign investment fund investments to that of domestic investment fund investments. However, since the tax rules were at the same time harnessed to support investor protection, a more disadvantageous tax treatment of investments made to non-registered investment funds – which therefore were not under the supervision of German regulatory authorities – was designed. Through harmful tax consequences German investors were effectively discouraged from acquiring units in non-registered investment funds. Meanwhile, however, the AuslInvestmG systematically treated income from foreign investment funds, even from those belonging to the white group, worse than the income from German investment funds was taxed under the KAGG. The approach of the InvStG seems to differ from this. It is arguable that InvStG serves in the first place as a means of an effective fiscal control. However, it clearly is also designed for preventing tax avoidance by means of foreign investment funds, since the quasi-penal taxation applied to black group funds under the AuslInvestmG has been included in the law, though in a milder form. Though also formally applicable to German investment funds, it is apparent that the main target has been foreign investment funds, in the knowledge that the risk of non-compliance is certainly higher in the latter case.

7.5.4 Assessment under Community Law

From the perspective of a single market, additional requirements imposed on foreign investment funds by a host state seem problematic. To the extent that such rules discourage fund promoters established in other Member States from offering units in the Member State, or at least make it more difficult for them to offer units cross-border than within the Member State, they result in an infringement of Article 49 EC enshrining the freedom to provide services within the Community. Such rules may also potentially discourage resident

investors from acquiring units of investment funds situated in other Member States. There are at least two potential sources of such a discouraging effect. First and foremost, the non-compliance by a foreign investment fund may be sanctioned by harmful tax consequences at the investor level. Secondly, the application of tax rules depending on the degree of compliance may generally cause uncertainty, as how investors are eventually taxed on their income from foreign investment funds. In all the cases referred to above, the rules may also be seen as an infringement of Article 56 EC, providing for the free movement of capital.

For the purposes of the following examination, it seems appropriate to distinguish between, on the one hand, the compatibility with Community law of tax reporting requirements imposed on investment funds by the Member States in their capacity as a host state of a foreign service provider (Issue 2a); and, on the other, the compatibility of tax sanctions attributed to resident investors in the case of non-compliance by anti-avoidance legislations (Issue 2b).

Issue 2a. In the first place, it is settled case law that the conditions imposed by a Member State, in its capacity as a host state, on non-resident taxpayers may result in a restriction of fundamental freedoms, even if such conditions were equally imposed upon resident taxpayers. In the *Futura* case, the Court stated:

> "[…] it must keep, in addition to its own accounts which must comply with the tax accounting rules applicable in the Member State in which it has its seat, separate accounts […] complying with the tax accounting rules applicable in the State […]"[1226]
> "[…] the imposition of […] a condition, which specifically affects companies or firms having their seat in another Member State, is in principle prohibited […]"[1227]

The *Futura* case concerned a branch of a company, established in another Member State, wishing to carry forward previous losses in the Member State in which the branch was situated. One of the conditions for such a carry-forward was that a taxpayer kept and held, within the Member State, the accounts showing the losses. The condition to keep and hold separate accounting in the Member State applied to non-residents, however, only in a case where they wished to carry forward losses. Nevertheless, it is arguable that the condition to keep accounts, even if only in the case of losses, was not as such discriminatory, since resident taxpayers were also naturally required to keep accounts, though irrespective of whether or not they intended to carry

[1226] *Futura,* Case C-250/95, para. 25.
[1227] *Futura*, Case C-250/95, para. 26.

forward losses.[1228] Notwithstanding that, the Court found such a condition restrictive, on account of the additional burden caused to the non-resident taxpayer. The conclusion of the *Futura* case must be that national measures, imposing certain conditions on non-resident taxpayers, cannot be considered compatible with Community law merely on the basis of the fact that the same requirements are applicable to residents.

In view of the subject of this study, it must be considered as to what extent a Member State as a host state may impose requirements, concerning tax reporting for tax purposes, on foreign investment funds established in other Member States or, alternatively, on resident investors in such funds. Reference may be made to a substantial body of case law concerning the freedom to provide services in the field of insurance (*Bachmann, Safir, Vestergaard, Danner, Skandia)* as well as to the above-referred *Futura* case.

The first remark to be made is that it is clear from the case law that national measures enacted in the general interest of safeguarding the effectiveness of tax control, and the prevention of tax avoidance are, in principle, compatible with Community law, even if these restrict fundamental freedoms. In the cases *Futura* and *Vestergaard*, the Court confirmed expressly that a Member State may apply measures which enable the amount of taxable income and deductible costs in the Member State to be ascertained clearly and precisely.[1229] However, the Court has also made it clear that the necessity and proportionality of the applied measures are subject to strict scrutiny. This strict approach is underpinned by the fact that the Court has never accepted restrictive national measures in the interest of effective tax supervision.

The second remark to be made is that the Court nonetheless has not generally applied the discrimination-based approach to measures which serve the interest of effective fiscal supervision. In other words, the Court has not condemned outright such national measures by stating that the same measures are not applied to domestic situations, but instead has applied the proportionality test, to examine whether the measures are in line with Community law. Therefore, it is arguable that the Court is willing to concede, though perhaps only to a very limited extent, that for the purposes of effective tax supervision there are factual differences between domestic and cross-border situations.[1230] The purpose of the following discussion is to examine to what extent the Court might be willing to accept tax reporting duties imposed on foreign investment funds in the host state.

[1228] See also Jiménez (1999) 239.

[1229] See *Futura,* Case C-250/95, para. 31 and *Vestergaard,* Case C-55/98, para. 25.

[1230] See also Terra – Wattel (2001) 66, who seem to agree with this view, but who at the same time express doubts as to whether this is also the Court's view since its reasoning in the *Vestergaard* case.

In view of the tax reporting requirements set by a host state on foreign investment funds, the *Futura* case is in many ways interesting. In its judgment, the Court accepted that the Member State could, in principle, require the non-resident taxpayer to keep separate accounting within the Member State, for the purposes of an effective fiscal supervision; but it considered that a requirement to keep accounts in the state only when a taxpayer wishes to carry forward losses was disproportionate to the aim of ascertaining the right amount of losses. More importanty, the Court stated that:

> ”The Member State concerned may, however, require the non-resident taxpayer to demonstrate clearly and precisely that the amount of losses which he claims to have incurred corresponds, under its domestic rules governing the calculation of income and losses which were applicable in the financial year concerned, to the amount of the losses actually incurred in that State by the taxpayer.”[1231]

It follows, from the Court’s statement above, that a Member State in its capacity as a host state may impose on a foreign investment fund a requirement to provide the tax authorities with the information needed for tax purposes. Moreover, the host state may require such information to be determined in accordance with its *domestic* rules governing the calculation of income for tax purposes. Against this, it seems that the required calculation of UK equivalent profits (UKEP) under the offshore funds legislation, as well as the rules of the InvStG concerning the determination of profits to be distributed (*Ausschüttungen)* and deemed to be distributed (*Ausschüttungsgleiche Erträge*) in accordance with German tax law, are basically in conformity with Community law.

Nonetheless, the Court has consistently implied that national measures are not the only possible means of acquiring information for the purposes of taxation in the Member States. In this respect, the Court stated in *Futura:*[1232]

> “[…] it is not essential that the means by which the non-resident taxpayer may demonstrate the amount of losses […] be limited to those provided for by [the Member State’s] law. Under [the Mutual Assistance Directive], the competent authorities of the Member State may always request competent authorities of another Member State to provide them with all the information enabling them to ascertain, in relation to the legislation which they have to apply, the correct amount of revenue tax payable by a taxpayer having his residence in that other Member State.”

This view has also been stated in comparable circumstances by the Court in *Bachmann*[1233]*, Vestergaard*[1234] *Danner*[1235] and *Skandia.*[1236] Any complaints by

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[1231] *Futura,* Case C-250/95, para. 43.
[1232] *Futura,* Case C-250/95, para. 40-41.

the Member States, of inadequacies in the Mutual Assistance Directive, have been consistently turned down by the Court.[1237] In this respect, the Opinion of Advocate General Jacobs in *Danner* is highly interesting, in that reference is made to the possibilities, provided by the Mutual Assistance Directive, for the Member States to engage in an automatic exchange of information required for tax purposes.[1238] However, that reference was not included in the Court's judgment. Nevertheless, it is clear, from the case law referred to above, that the possibilities offered by the Mutual Assistance Directive restrict severely the Member State's possibilities of reliance upon restrictive national measures in the interest of effective tax supervision. The question is whether the Court has adopted the view that the Member States should exhaust all the possibilities – not only the practical but also the theoretical possibilities – of information exchange offered by the Mutual Assistance Directive before relying on national measures.[1239] Should this be the case, it would be difficult to see any room for national measures which affect, for example, non-resident service providers or recipients of cross-border services, as the Mutual Assistance Directive makes it possible for the Member States to exchange all information which, in the words of the Directive, may enable them to effect a correct assessment of taxes on income and on capital.

However, there are indications in the Court's case law that the Court has not (yet) gone so far. Here reference may be made to the same line of case law (*Bachmann, Vestergaard, Danner, Skandia).* In each of the cases, the Court has emphasized that:

> "There is nothing to prevent the tax authorities concerned from requiring the taxpayer to provide such proof as they may consider necessary in order to determine […]"[1240]

It follows that the Court recognises a Member State's need to have at least a certain discretion (cf. "as they may consider necessary") as to what kind of information is needed for tax purposes in the Member State. However, it is not entirely clear to what extent the burden of evidence may be different in domestic and cross-border situations. It is arguable that some difference may

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[1233] See *Bachmann,* Case C-204/90, para. 18.
[1234] See *Vestergaard,* Case C-55/98, para. 28.
[1235] See *Danner,* Case C-136/00, para. 49.
[1236] See *Skandia*, Case C-422/01, para. 42.
[1237] See *Skandia,* Case C-422/01, para. 38 ff; *Danner,* Case C-136/00, para. 47 ff.
[1238] See para. 73 of the Opinion of Advocate General Jacobs in *Danner,* Case C-136/00.
[1239] See Borgsmidt (1999) 61, who argues that the effectiveness of fiscal supervision cannot be invoked, unless all the possibilities of co-operation between national tax authorities of Member States provided by the Mutual Assistance Directive have been exhausted.
[1240] See *Bachmann,* Case C-204/90, para. 20; See *Vestergaard,* Case C-55/98, para. 26; *Danner,* Case C-136/00, para. 50; *Skandia*, Case C-422/01, para. 42.

exist[1241], though only within the limits of the necessity and proportionality tests.

On the other hand, there is a difference between the case of requiring information from a resident taxpayer individually, and the case of national laws imposing tax reporting requirements on foreign investment funds. Only in the former does the Member State's need to demand tax relevant information relate to the taxpayer's own taxation in the Member State. However, in the case of foreign investment funds, the provision of tax relevant information serves to facilitate more effective taxation of resident investors participating in such funds. It is arguable that there is a difference between the cases of resident and non-resident investors. In the case of the former, such reporting requirements apply to investors which are already subject to worldwide taxation and to the comprehensive tax reporting requirements of the Member State in which they are resident; whereas non-resident investors – being already subject to reporting requirements in their own state of residence – have an additional burden placed upon them through the further demands of the Member State in question.

Here reference can be made to the *Bachmann* case, where the Court examined the possibilities for a Member State to ensure the future taxation of amounts payable by a non-resident insurance company in the hands of a resident investor, doing so, however, in the context not of effective supervision, but of the cohesion of the tax system. As one of the options, the Court considered the possibility of the Member State's requiring the foreign insurance company to provide a deposit of guarantee, which would essentially secure the recovery of the future tax claim in the Member State.[1242] Owing to the extra cost resulting from the arrangement to the insurance company, which would eventually also be reflected in the level of insurance premiums payable by the investor, the Court nonetheless finds the arrangement restrictive.[1243] Reference can also be made to the Opinion of the Advocate General in the

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[1241] See Terra – Wattel (2001) 66, with reference to the Court's judgment in *Vestergaard.* The case involved a reversed burden of proof on the taxpayer, with respect to certain tax deductions, when the cost had been incurred abroad rather than within the jurisdiction of the Member State involved. The Court found this to be incompatible with Community law. However, the judgment has been interpreted as not meaning that a greater burden of proof with respect to cross-border activity would not be permitted under Community law, but rather that a case-by-case analysis must be made by national tax authorities, to ascertain whether a greater burden of proof may be demanded from the taxpayer, rather than applying a presumption affecting all cross-border activities without regard to factual circumstances. See Terra – Wattel (2001) 66; Pistone (2002) 155-156.

[1242] *Bachmann,* Case C-204/90, para. 25.

[1243] The Court's arguments have been criticized by van Thiel (2001) 248 footnote 759, who considers that it is not for the Court to decide whether the insurance company is in the position to offer competitive insurances in the Member State's market, even if it has to provide for a deposit to ensure the payment of the tax by the insured.

Danner case, where Advocate General Jacobs considers alternatives to secure effective taxation of income from foreign insurance schemes:

> "[…] perhaps most importantly, it seems to me that a Member State can ensure that insurance undertakings established abroad cooperate and provide the necessary information about the payments which they make to residents. A Member State may for example make the deductibility of contributions to a given foreign institution scheme conditional on a prior arrangement between that institution and the authorities of the Member Staet concerned. In such an arrangement the Member State could require the provision of full and accurate information about the pension payments made by that institution […]"[1244]

The Court however did not include the above-quoted statement in its judgment. Arguably, the arrangements suggested by the Advocate General might raise the question as to whether the precondition of deductibility under the proposed arrangement would be proportional, in view of the fact that it affects all foreign insurance takers, and companies wishing to offer their services in the Member State (cf. *Vestergaard* above).

Based on the *Bachmann* case, it may nonetheless be inferred that the Court does not, as such, see it as inappropriate for Member States to impose obligations on non-resident persons, such as providers of financial services, in order to ensure the taxation of its resident investors. It is clear, however, that any additional obligations risk being disproportional. In particular, it must be noted that, in the *Bachmann* case, the Court found the denial of tax deduction by the insurance taker in the Member State, on grounds of the cohesion of the tax system, to be less restrictive than the obligation of the insurer to provide for a deposit of guarantee, reasoning which has been criticized.[1245]

As for the case of foreign investment funds, it is obvious that complying with the information requirements set by the host state will add to costs incurred by an investment fund. In line with the Court's reasoning in *Bachmann*, it may be argued that such additional costs will then be reflected in the management fee, thereby making an investment in a foreign fund more expensive and less attractive for an investor. However, the appropriateness of this line of reasoning seems doubtful, and several counterarguments may be produced. In the first place, the reason for an investment fund to offer its units cross-border is to acquire new investors, which in turn will benefit the fund in the form of economies of scale. For example, in a case where the potential investor base in the host state is sufficiently large, in proportion to existing investors, the impact of additional costs resulting from compliance per unit

[1244] See Opinion of Advocate General Jacobs, *Danner,* Case C-136/00, para. 74.
[1245] See van Thiel (2001) 246 ff; Terra – Wattel (2001) 68.

will be diluted, and other benefits related to economies of scale[1246] may outweigh any disadvantages caused by compliance efforts in the host state. Secondly, it is arguable that the information duties imposed by the host state do not essentially change the conditions of competition, as the costs resulting therefrom are not likely to be of major significance. For example, in the case of the United Kingdom and Germany, there is no need to produce separate accounts in accordance with the host state regulations – rather, the accounts kept in accordance with the tax rules of the home state are adapted to those of the host state.[1247] In addition, the publication requirements concerning certain tax relevant information under the InvStG do not significantly add to the costs, as there is in any case the general requirement, in accordance with the UCITS Directive, to publish regularly the price of the fund unit, in accordance with the rules in force in the host state. Finally, it may be noted that resident investment funds are generally bound by similar or comparable rules concerning tax reporting, although it is arguable that the relative burden of compliance is lighter, on account of the fact that they are more familiar with the tax accounting rules of the jurisdiction.

Generally speaking, it may be said that rules concerning tax reporting and the publication of all relevant information are not likely to be seen as being disproportionate to the aim of safeguarding the effectiveness of fiscal control. Moreover, the information required for deemed distribution purposes (in Germany) and for a distributing fund -status (in the United Kingdom) are hardly obtainable under the Mutual Assistance Directive, so that the test of proportionality obviously cannot be infringed. In the first place, the information required for these purposes may not be necessary for tax purposes in the home state of an investment fund and therefore would not be readily, if at all, available for home state tax authorities.[1248] Moreover, even if available, the information must be adapted to tax rules effective in the host state jurisdiction, which is unlikely to be possible without the co-operation of the fund. A certain reservation must nevertheless be made, in view of the fact that the Court has arguably often disregarded the complaints of the Member States concerning the inadequacies of the Mutual Administrative Directive.

[1246] For example, lower brokerage fees incurred per unit.

[1247] The relative burden caused by the compliance in the host state, of course, varies case by case. Should an investment fund already in its home state be under comprehensive accounting and tax reporting obligations, the relative burden caused by host state obligations is less. However, should there be no comprehensive accounting and tax reporting requirements in the fund’s home state, the relative burden in the host state would be greater. Therefore, the burden caused by the adaptation of accounts to the tax rules of the host state varies on a case-by-case basis. This is also highlighted in the Inland Revenue (2002b) 4.12-4.14 where the possible concerns of fund managers with regard to provisions concerning UK equivalent profits in the offshore funds legislation are expressed.

[1248] For example, Finnish and Luxembourg funds need not produce information for deemed distribution purposes in their home jurisdictions.

On the other hand, the above does not totally exclude the possibility that certain elements in the legislation might be suspected of being unnecessary or disproportionate in view of the aim pursued. For example, there is case law (*Safir)* by the ECJ which suggests that attention will generally be paid to transparency of legislation.[1249] Rules which are too dubious and difficult to comply with may fail to meet the test of proportionality. Secondly, according to the same case law, procedural requirements may be subject to scrutiny by the Court. In *Safir,* the Court considered obligations imposed on individual policy-holders to be restrictive – obligations including, for example, an obligation to register a foreign insurance policy with the tax authorities. In addition, there was a burdensome procedure of applying for exemption from the premium tax – a procedure which made a policy-holder itself generally liable to acquire, and to provide the tax authorities with, information concerning the taxation of the foreign insurer. [1250] Consequently, the certification procedure under the UK offshore funds legislation might attract the Court's attention. However, in conclusion, and with a note of caution, it is submitted that the tax reporting obligations imposed by the German InvStG and the UK offshore funds legislation are basically in line with Community law requirements.

Issue 2b. Apart from the obligations concerning tax reporting, attention must be paid to the compatibility of sanctions resulting from non-compliance with such obligation. Both the UK offshore funds legislation and the German InvStG impose certain tax sanctions, as specified in the respective regimes, on underlying investors of non-complying investment funds, which in effect result in a higher tax burden at the investor level than that resulting in the case of complying investment funds.[1251]

From the outset, it must be mentioned that the starting point of the examination of the UK offshore funds legislation, on the one hand, and of the German InvStG*,* on the other, is different. As to the tax sanctions imposed by the UK offshore funds legislation, they risk being discriminatory as such, in that they are applicable exclusively to investors of foreign investment funds. It is worth mentioning that this was also the case for the repealed AuslInvestmG*,* whereas its successor, the InvStG, applies indiscriminately to investors both in German and in foreign investment funds. As a result, from the point of view of discrimination within the meaning of Community law, there is a decisive difference between the UK offshore funds legislation and the repealed

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[1249] See *Safir*, Case C-118/96, para. 33, where the Court expressly suggests a more transparent tax system treating domestic and cross-border situations in the same way.

[1250] See See *Safir,* Case C-118/96, para. 26 ff.

[1251] See discussion in Chapter 5.2.2. concerning the United Kingdom and Chapters 5.3.1.-5.3.2. concerning Germany.

AuslInvestmG, on the one hand, and the InvStG, on the other. It is clear that the InvStG is not discriminatory, in the sense that investors of non-complying domestic and foreign investment funds, which essentially are in a comparable situation, will confront the same disadvantageous tax consequences.

Notwithstanding the above, the establishment of discrimination in the case of the UK offshore funds legislation is not straightforward. Obviously, as regards the imposition of tax sanctions, the comparability test should be made between investors in non-complying UK funds and those in non-complying foreign funds. However, under the UK tax regime there cannot be non-complying UK funds, since they are not required to have their income distributed annually, even though the investor is taxed on the yearly income under the deemed distribution rules. Moreover, UK resident investors in non-complying foreign investment funds are not generally taxed on a deemed distribution basis, save in the case where the investment fund is clearly transparent, but are permitted to accumulate the income and therefore to defer UK taxation on the income. As stated earlier, a case-by-case analysis should, in principle, be made, in order to establish whether the offshore funds legislation in fact results in a higher tax burden – although for the Court it may be sufficient to establish that in certain cases a disadvantage may potentially arise.

Moreover, despite the fact that the sanctions attributed by the InvStG are applied in a non-discriminatory way, the possibility cannot be excluded that they might potentially result in an infringement of fundamental freedoms. It is arguable that domestic investment funds are in a better position to comply with the requirements set for the more favorable tax treatment, than are foreign investment funds. Therefore, at the very least, InvStG may also potentially contain certain elements which may result in a restriction of fundamental freedoms.

As a result, examination is necessary, in order to see whether the disadvantageous tax consequences imposed on investors of non-complying foreign investment funds serve the aim of prevention of tax avoidance, and whether or not they are disproportionate to the aim pursued. The aim of sanctions is obviously to force foreign investment funds to comply with the rules concerning tax reporting as regards the taxable income, and therefore to prevent tax avoidance by resident investors.[1252] It follows from the Court's case law that preferential tax treatment may be denied in the case of abuse such as tax avoidance (e.g. *Leur-Bloem, ICI, Lankhorst-Hohorst, X and Y).* However, the same line of case law demonstrates clearly that, from the

[1252] See Plewka – Watrin (2001) 2268.

Community law point of view, the acceptability of any national anti-avoidance measures is subject to the strict necessity and proportionality tests.

In the first place, the problem seems to be that the sanctions are not attributed to a non-complying fund, but rather to its underlying investors. This, of course, is natural owing to the fact that it is the underlying investors who are liable to tax on their income from the foreign investment fund in the host state, whereas the investment fund typically bears no tax liability in the state unless it receives income subject to tax therefrom.[1253] Thus, the host state is generally not in a position to impose any tax penalty on non-complying foreign investment funds.[1254] However, there remains asymmetry insofar as the compliance with the rules rests on the foreign investment funds, whilst the sanctions of non-compliance are borne by underlying investors. The question must arise whether the ECJ would allow such asymmetry to exist, without the host state having to provide underlying investors of a non-complying fund with a means of avoiding harmful tax consequences, by way of self-compliance at the investor level. It must be admitted that such self-compliance by individual investors – in order to fulfill the obligations imposed on an investment fund – is likely to be extremely burdensome, and therefore to remain only a theoretical possibility for the avoidance of harmful tax consequences resulting from the investment fund's non-compliance. However, the line of case law referred to above suggests that the ECJ is sensitive to standardized rules which treat the addressed situations in too general a way, without a case-by-case evaluation. In line with this, it is arguable that there should be an escape clause for an individual investor of a non-complying fund, providing for the (theoretical) possibility of avoiding threatening harmful tax consequences by fulfilling the necessary obligations personally. Whereas under the UK offshore funds legislation this possibility exists, it is understood that under the InvStG, there is no such alternative.

A further problem, also stemming from the asymmetry referred to above, is the uncertainty regarding the investment fund's compliance with the tax reporting or other obligations, and thus regarding the tax treatment of an investor, who, or which, is essentially dependent on the compliance issue. In the *Safir* case, the Court expressly considered uncertainty over applicable tax rules, caused by the assessment procedures and discretionary powers of tax authorities, to be harmful for the investor.[1255] Although the investor, as a general rule, is aware of the tax compliance status of the investment fund at

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[1253] See Plewka – Watrin (2001) 2268.

[1254] Other non-tax related sanctions are in principle conceivable, such as restrictions on public distribution of units in non-complying foreign funds. However, such sanctions also risk being incompatible with Community law.

[1255] See *Safir,* Case C-118/96, para. 29.

the moment of acquisition[1256], this does not necessarily guarantee (favorable) tax treatment over the holding period until the disposal. This is because the anti-avoidance regimes are generally applied retrospectively, with the consequence that the fund must generally meet the requirements set for the favorable tax treatment each year. Should the fund fail to fulfil its obligations over the investor's holding period, this would generally lead to disadvantageous tax consequences at the investor level. Under the InvStG, in an extreme case the penal-style tax consequences could destroy the yield of the investment.[1257] As concluded in the preceding discussion, the same possibility of avoiding disadvantageous tax consequences at the investor level, in the event of the fund's non-compliance, is likely to be necessary from the perspective of proportionality of anti-avoidance measures. However, as to the straightforward problem of uncertainty on the applicable tax treatment caused by the regimes discussed here, it seems inherent in such regimes, so that it is difficult to foresee the fund's compliance with the rules over the whole period of holding by an investor.

It is submitted here that more burdensome tax consequences, brought about by national anti-avoidance legislation in the case of non-compliance, are basically compatible with Community law, provided that there is an escape clause for investors having no abusive intentions. The fact that the same sanctions are applied in the case of both domestic and cross-border fund investments may increase the possibilities for EC-compatibility, although it is submitted that this need not necessarily be the case, owing to the fact that a comparable situation may not occur in a purely domestic case, as the UK example demonstrates. However, as in the case of tax reporting requirements, a note of caution must be added, in view of the Court's strict approach when applying the proportionality test. In particular, Member States should pay attention to the severity of the tax consequences, and of the burden of proof, as regards the possibilities of avoiding the application of the anti-avoidance legislation in non-abusive cases. By the same token, too onerous or intransparent procedures, related to tax reporting and certification (UK), or to tax reporting and publication (Germany), might invite some closer scrutiny by the Court, although such matters are always subject to interpretation.

[1256] For example, at the time of the AuslInvestmG, German tax authorities used to publish (unbinding) lists of foreign investment funds stating their tax status. Also brochures of funds distributed to German investors usually offered some (unbinding) information as to the pursued tax classification under the German AuslInvestmG. It has been sometimes the practice of German institutional investors to demand from the foreign investment fund (the units of which they intend to purchase) a written commitment to comply with the rules of the AuslInvestmG.

[1257] See Schultz (2002) 31, with respect to taxation of black group funds under the repealed AuslInvestmG.

7.6 Tax Treatment of Non-Resident Investors of Domestic Investment Funds

7.6.1 Issues – Withholding Taxes & Eligibility for Tax Benefits at Source

The tax treatment of non-resident investors of domestic investment funds in Member States raises at least two issues which are of interest from the perspective of Community law. In the first place, non-resident investors are typically subject to limited tax liability on the income received from domestic investment funds. However, the tax liability under national tax laws is often restricted to distributions, capital gains being tax-exempted in the hands of private portfolio investors.

Table 13. Tax Liability on Income from a Domestic Investment Fund.

	Resident investor			Non-resident investor[1258]		
State	dividend	interest	capital gain	dividend	interest	capital gain
UK	(10-32,5%)	(10-32,5%)	(M)	-	(0-20%)	-
GER	(M)	(M)	(M)[1259]	(20 %)	(30%)	-
FRA	(M)	(M)	(16%)	(25 %)	-	-
FIN	(29%)	(29%)	(29%)	(29 %)	(29%)	-

(X) = tax liability, – = no tax liability, M = marginal rate of tax applicable

To the extent that the income is subject to tax, the tax rate can often be reduced under an applicable tax treaty. Most states would classify the fund distribution as dividend for tax treaty purposes, with the effect that the tax rate does not exceed 15 per cent. In certain cases, tax treaty provisions may be applicable in accordance with the original items of income. Yet, in exceptional cases, the whole fund distribution may be qualified as other income for tax treaty purposes, with the consequence that no withholding tax is generally levied.[1260]

In terms of applicable tax rates, non-resident investors are not generally taxed more severely than resident investors in the Member States, even if the impact of tax treaties is disregarded. Where, however, the income from an investment fund is taxed in the hands of resident investors in accordance with marginal tax rates, a case-by-case analysis would, in principle, be needed to gain certainty over whether a non-resident investor is in fact taxed more

[1258] Tax liability under domestic tax law without regard to tax treaties.
[1259] Depending on the holding period of shares.
[1260] This is generally the case in Finland.

severely than a resident investor. Should the impact of an applicable tax treaty be taken into account, the probability of a non-resident investor being taxed at a higher rate than a resident investor would considerably diminish.

Nevertheless, the applicable tax rates are not the only difference arising when taxing resident and non-resident investors in the Member States. In addition, the method of calculating the taxable income may also differ as between the different categories of taxpayers. While resident investors are, as a rule, taxed on a net-income basis, non-resident investors are taxed on a gross-income basis, without the possibility of deducting incurred costs from the taxable income in a Member State. However, such a deduction would generally be possible in the residence state of an investor.

This second issue relates to the internationally established practice, that non-resident investors are not generally eligible for tax benefits in the same way as resident investors of a Member State. It is possible that comparable benefits are available in the residence state of the non-resident investor, but this is not necessarily the case. Consequently, the United Kingdom does not extend the imputation credit, in respect of dividends distributed by the UK investment fund, to non-resident investors. As regards the residence state of the non-resident investor, it is an established practice that imputation credits are not extended to income received from foreign investment funds. However, a German investor would benefit from the half-income system, in respect of income received from a UK investment fund. France does not extend the allowance in respect of French-source dividends to non-resident investors. On the other hand, tax credits – including *avoir fiscal* and foreign tax credits – may, under certain conditions and subject to limitations, be deducted against the applicable withholding tax at source in France. In Germany, the half-income system is applicable only to dividends received by resident investors, even though for withholding tax purposes both resident and non-resident investors are taxed on the total amount of dividends. Also the annual allowance with respect to dividend and interest income is available only to German resident investors.

7.6.2 Assessment under Community Law

Each of the issues presented above relates to the broader question as to what extent, under Community law, may non-resident investors be treated differently in the source state of income, as compared to resident investors. Therefore, the issues discussed here are not specific to investment fund investments, but apply generally to all types of portfolio investments. It is even arguable that they are of greater significance in the case of direct

investments made without an investment fund, because, in the former case, private investors can more easily decide not to receive any distributions, thereby realizing the income in the form of capital gains not subject to withholding tax. In addition, it may be noted that the Court's case law has so far been concentrated on the treatment of non-resident employees in Member States, as far as the taxation of individuals is concerned. To date, there is no case law on the treatment of non-resident private portfolio investors in a Member State. Conversely, the case law has so far restricted to the tax treatment of resident individual investors with cross-border investments in Member States (*Safir, Verkooijen*).[1261]

Withholding taxes at source. It follows from the Court's case law concerning employees and self-employed persons (e.g. *Asscher, Gerritse)* that non-resident persons must not be subject to higher tax rates in a Member State than resident persons. However, owing to the fact that residents are often taxed at progressive rates of tax, whereas non-residents are subject to a flat rate of withholding tax, it is often not readily clear whether or not the latter, in comparison to the former, are taxed unfavorably in a given Member State. The same body of the Court's case law also shows that the impact of an applicable tax treaty on the taxing rights of the involved Member States must be taken into account[1262]. Finally, the taxation of the non-resident person in his own Member State should not be disregarded. The taxation in the residence state is of significance in two respects. In the first place, the Court pays attention to whether tax benefits, comparable to those conferred by a Member State on resident investors, are available for the non-resident person in his own residence state.[1263] In the second place, the Court pays attention to whether or not the income is subject to progressive taxation in the residence state of the non-resident investor.[1264]

When it comes to non-resident individual investors, their situation is in many ways different from that of self-employed persons, as in the *Asscher* and *Gerritse* cases. In the first place, under tax treaties, the taxing right of portfolio income is often shared between the source state and residence state, the latter state being obliged to credit taxes paid in the former. Conversely, in the *Asscher* and *Gerritse* cases, the income was taxed only in the source state of income, with exemption with progression being applied in the residence state. It follows that in the case of non-resident investors, the eventual tax liability

[1261] In the case *Verkooijen*, the investor involved had acquired foreign shares in the context of an employees' savings plan. However, the situation of the investor was comparable to any portfolio investor. In addition, there is the pending case *Manninen,* pending Case C-319/02, involving an individual investor with a foreign share holding.

[1262] See *Asscher,* Case C-107/94, para. 47; *Gerritse,* Case C-234/01, para. 52.

[1263] See *Asscher,* Case C-107/94, para. 44; *Gerritse,* Case C-234/01, para. 51.

[1264] See *Asscher,* Case C-107/94, para. 48; *Gerritse,* Case C-234/01, para. 52-53.

on the income will be determined in accordance with the tax laws of the residence state, whereas in the *Asscher* and *Gerritse* cases, the tax liability on the income was determined merely in accordance with the laws of the source state.

Secondly, the tax rate in respect of portfolio income in the source state is limited to a maximum of 15 per cent, whereas in the case of the types of income concerned in the *Asscher* and *Gerritse* cases, no such limitation exists. In view of the relatively low rate of withholding tax on portfolio income in the source state of income, it is unlikely that the applicable tax rate would exceed the one applicable to resident investors of the Member State.

Apart from the applicable tax rate, the amount of tax payable is affected by the way in which the tax basis is calculated. In this regard, there is generally a difference between resident investors, taxed by way of assessment on a net-income basis, and non-resident investors, subject to withholding taxation on a gross-income basis.

The compatibility of gross-income based taxation in the case of non-resident persons was raised in *Gerritse.* The Court found that there is no objective difference between residents and non-residents, as far as the deduction of business expenses is concerned, since in both the cases (in the Court's words) such expenses were directly linked to the activity that generated the taxable income in Germany.[1265] The Court seems to have followed its earlier case law involving objective tax benefits, in that it paid no attention to the question of whether or not such benefits were available in the residence state of the non-resident person, although in *Gerritse* it was clear that this was not the case, since the relevant income was exempted in the residence state. In the case of individual investors, however, foreign-source investment income is liable to tax in the residence state net of expenses, with a credit given for any taxes incurred in the source state of income. Nonetheless, owing to the tax credit mechanisms, based on the ordinary credit method generally applied to portfolio income, a part of withholding taxes attributable to deductible costs remains practically uncreditable in the residence state.

Would the Court, in that case, uphold its position as to the comparability of the situations of resident and non-resident investors? In light of the reasoning in *Gerritse* this seems possible, since the Court has paid attention only to the fact that deductible expenses are directly linked to the activity, the income on which is liable to tax in the Member State. The same line of reasoning could be applicable to costs related to investment income. On the other hand, it is also possible that, owing to the fact that, under tax treaties – and also

[1265] See *Gerritse,* Case C-243/01, para. 27.

according to the OECD Model Convention[1266]– the final taxing jurisdiction of investment income is allocated to the residence state of an investor, the Court might be willing to apply the line of reasoning adopted in its case law concerning person-related tax benefits. Consequently, the Court might follow the assumption that it is the residence state which is in a better position – if only for practical reasons and not because of the concentration of income in the state – to take account of such expenses in the taxation. In view of the existing case law, no definite answer can be given to the question presented.[1267] Nonetheless, below are addressed some of the foreseeable issues which would arise if the source state were required to allow deduction of expenses even for non-resident investors.

Even if the Court were to find that denial of deduction of expenses is in conflict with fundamental freedoms, it is unlikely that Community law would require an outright prohibition of gross-income based withholding taxation in the source state. Rather, in accordance with the Court's wording in the *Gerritse* case, it is arguable that it suffices for Member States to provide non-residents with a *possibility* to deduct expenses from the taxable income.

> "[…] precludes a national provision […] in so far as it excludes the possibility for partially taxable persons to deduct business expenses from their taxable income, whereas such a possibility is granted to wholly taxable persons."[1268]

In view of the nature of withholding tax procedure where a great number of investors is involved, and of the fact that expenses related to investment income, such as deposit fees, are not necessarily known at the moment of receipt of income, the deduction of expenses would obviously require the non-resident to be taxed by way of an individual assessment, with a possibility to obtain a refund for excess withholding taxes. It is also to be noted that resident investors are typically subject first to gross-income based withholding taxation on their investment income, with a possibility to deduct income-related expenses in their final taxation. Therefore, the same right conferred on non-resident investors, to become taxed by way of an assessment in the same way as resident investors, should meet the requirements of Community law.[1269] In

[1266] Cf. the Court's reference to the OECD Model Convention in *Gilly*, Case C-336/96, with respect to allocation of taxing jurisdiction.

[1267] Cf. Mattsson (2003) 192, who remarks, with respect to person-related tax benefits, that there is no case law where the taxpayer would have been allowed to avail himself of such benefits in the state of employment on account of the size of income, and the residence state would, under the tax treaty, also have the right to tax the income.

[1268] *Gerritse,* Case C-234/01, para. 29.

[1269] Cf. Molenaar – Grams (2003a) 203, who argue that, in the case of artistes and sportsmen, only a deduction of expenses prior to the levy of withholding tax is in line with Community law. In their view, an income settlement with a deduction of costs would not satisfy Community law requirements owing to cash flow disadvantage caused to non-residents.

any event, from a pragmatic point of view, it may be questioned whether such a procedure would not be disproportionate for most investors, in view of the often negligible expenses related to investment income, in contrast to expenses related to business expenses which are generally higher. This is particularly true in respect of distributions derived from investment funds, where most expenses are already deducted from managed assets at the fund level. Furthermore, the deduction of expenses in the source state should be only fractional[1270] because a tax treaty would typically limit the source state's taxing right on the investment income.[1271]

Tax benefits. In addition to withholding taxes, it must be considered whether, and under which conditions, Community law requires that certain tax benefits related to fund distributions, and currently available only for resident investors, be extended to non-resident investors from other Member States.

When it comes to imputation credit attached to dividend distributions from UK investment funds, the *Avoir fiscal* case is helpful. In the *Avoir fiscal* case, the denial of imputation credit from permanent establishments of non-resident companies was in conflict with Community law. However, in its reasoning, the Court emphasised the fact that resident companies and permanent establishments were treated similarly for tax purposes in the Member State, which in effect makes the situations of residents and non-residents comparable for Community law purposes.[1272] When it comes to dividend distributions from UK investment funds, the situations of resident and non-resident investors are not comparable, as the latter are not subject to tax on their income in the United Kingdom. Even under the restriction-based approach, it seems obvious that non-residents are not discouraged from investing in UK investment funds because of non-extension of imputation credits. Their tax liability being nil in the United Kingdom, it can never be greater than that of resident investors.[1273]

In Germany, the half-income system is applied to dividend income received by resident investors whether directly or through an investment fund. As far as non-resident investors subject to limited tax liability in Germany are concerned, the half-income system is not applied to dividends, irrespective of whether received directly or through a German investment fund. Consequently,

[1270] I.e. the tax treaty rate, divided by the applicable tax rate to investment income under national law, multiplied by the amount of deductible expenses.
[1271] This issue did not arise in *Gerritse* because the income was exempted in the residence state. An additional problem might arise as regards the deductibility of interest on a possible loan used to acquire the assets producing the taxable income. Under which conditions and to what extent should such interest be deductible in the source state? See also Hinnekens (2003) 211, with respect to questions arising from the *Gerritse* case in view of the deductibility of costs.
[1272] See *Avoir fiscal,* Case 270/83, para. 19-20. See also Vapaavuori (2003) 307; Terra – Wattel (2001) 74; Ståhl (1996) 206.
[1273] See also de Bont (1995) 141. An opposite opinion is expressed by Knobbe-Keuk (1992) 30.

the whole amount of dividends is subject to a final withholding tax at a rate of 20 per cent, or at a lower rate if provided by a tax treaty (mostly 15 per cent)[1274]. The question must arise as whether the exclusion of non-residents from the application of the half-income system is compatible with Community law.[1275]

Unfortunately, the same difficulty of assessing the situation in light of the current case law as in the case of deduction of expenses arises. In the first place, the taxing right of income is shared by the source state and residence state so that, in principle, both states are in a position to grant a relief on the taxation. In accordance with the settled case law (e.g. *Schumacker*), it is generally the residence state which has greater opportunities to grant tax relief as far as this relates to the personal circumstances of the taxpayer. However, the relief provided by the half-income system clearly qualifies as income-related tax benefit, in which case the benefit should, as a rule, be available for non-residents on the same footing as for residents, provided that the two categories of taxpayers are in a comparable situation. Unlike in the case of the United Kingdom dealt with above, the situations are likely to be comparable, as both categories of taxpayers are subject to tax on the income in the source state of income.

Whether the different treatment is disadvantageous for non-resident investors in the source state of income will depend, in the end, on the marginal tax rate of a comparable resident investor. With a withholding tax of 15 per cent, the non-resident's tax liability in Germany corresponds roughly to that of a resident person taxed at a marginal rate of 30 per cent on the same income. Whether, in these circumstances, a breach of Article 56 EC could possibly arise in the Court's view cannot be answered with full certainty. This would also depend on whether the Court would assess the overall tax situation of a non-resident investor. Should this be the case, there can hardly be any breach of Community law, owing to the fact that the final tax liability would in any case depend on the tax rate applicable to the income in the residence state of the investor, with a credit being granted for taxes levied in Germany.[1276] However, as noted earlier in this study, so far the Court has paid attention to

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[1274] See European Tax Handbook (2003) 237-238.

[1275] In German tax literature, some doubts have been expressed on the compatibility. See, for example, Berger-Quack (2001) 85, with respect to individual investors. See also Dautzenberg (2001) 2139 ff., who examines the incompatibility of the German dividend tax system from the perspective of companies. His conclusion is that the exemption of only German resident companies from taxation of dividends, whilst at the same time non-resident companies are subject to withholding tax on (portfolio) dividends at source in Germany, is in conflict with Art. 56 EC.

[1276] Therefore, should Germany extend the half-income system to dividends paid to non-residents, the result would, from a non-resident investor's perspective, be a lower tax credit in the residence state, the final tax liability remaining the same.

the overall tax position only where person-related tax benefits are at stake, which is not the case here.

Finally, it must be considered whether the tax allowances applied by Germany and France with respect to dividends are compatible with Community law, despite the fact that they are confined to resident investors.[1277] In assessing the situation, similar circumstances as in the case of the German half-income system prevail. Firstly, the income is taxable both in the source state and in the residence state, which would point to the residence state's greater possibilities for granting such tax allowances. In the *Gerritse* case, the Court considered that a non-resident person was not entitled to benefit from a tax-free allowance deductible from a taxpayer's overall income, owing to the fact that a comparable allowance was also available for the person involved in the residence state.[1278] However, it is not clear whether the tax free allowance at issue in *Gerritse,* which aimed at guaranteeing an essential minimum of income for a taxpayer, and those at issue here, which do not have the same social purpose, are comparable in the Court's view. Rather, it is arguable that the allowances applied by Germany and France are purely income-related, in which case the Court would not necessarily depart from the assumption that it is the residence state which generally allows such benefits.[1279]

The *Gerritse* judgment also leaves open the question of what would have happened if there were not a comparable tax allowance in the residence state of the taxpayer. This question is of relevance, in view of the type of allowances under consideration here, since, for example, of the countries covered by this study, the United Kingdom and Finland do not apply such allowances. There are at least two possible answers. First, in that case, the Court might conclude that, in view of the possibility of benefiting from a tax allowance, the resident and non-resident investors are not in a comparable situation.[1280] Second, the Court might follow its case law, involving income-related tax benefits, and conclude that the same benefits which are conferred on residents must be allowed for non-residents by the source state of income.

[1277] See Prats (1998) 184, who considers that in Spain the tax-exemption up to a certain amount, applicable to capital gains and only available to resident investors, might be in conflict with the free movement of capital.

[1278] See *Gerritse*, Case C-234/01, para. 51.

[1279] See *Gerritse*, Case C-234/01, para. 48, where the Court states: "[the tax free allowance] has a social purpose […] it is legitimate to reserve the grant of that advantage to persons who have received the greater part of their income in the State of taxation, that is to say, as a general rule, residents."

[1280] Cf. Mattsson (2003) 188, who considers that, in the *Schumacker* case, the fact that there were similar tax benefits available in the non-resident person's residence state as there were in the state of employment, was the other condition – in addition to concentration of income – for the situations to be comparable.

Unfortunately, in the absence of specific case law on the issue in question, no definite answer can be given.

7.7 Investment Fund Investments and Tax Treaties

7.7.1 Issue – Tax Treaty Provisions Affecting Investment Funds

In this section the compatibility of tax treaties with Community law from the perspective of investment fund investments will be examined. While there generally are a variety of tax treaty provisions which can conflict with Community law, the following discussion concerns itself with the compatibility issues arising from the interpretation of tax treaty provisions in the context of investment fund investments. Therefore, the discussion concentrates only on provisions which are of relevance with a view to establishing whether investment funds or their investors are eligible for tax treaty benefits.

As shown in Chapter 4 of the study, the tax treaty access of investment funds is a very delicate issue. On the one hand, investment funds may not fulfill the general conditions of tax treaty access relating to persons and residence as laid down in the OECD Model Convention. On the other hand, investment funds may also be denied tax treaty benefits, wholly or in part, on grounds of anti-abuse measures such as beneficial ownership or various other limitation-of-benefits provisions. In addition, should the fund not be entitled to tax treaty benefits, the possibilities for underlying investors to receive such benefits must, in principle, be considered. For the most part, however, it was submitted in Chapter 4.4.5 that practical difficulties eventually prevent individual investors from claiming the benefits, even if, in theory, such may be available.

The unavailability of tax treaty benefits, in the form of a lower withholding tax at source, and of a credit for the remaining withholding taxes – either in the residence state of the fund ('fund access') or the investor ('investor access') – results in a greater tax burden on cross-border investments as compared to domestic investments through an investment fund. This obviously is in conflict with the objective of a single capital market involving the free movement of capital. However, owing to the involvement of up to three different Member States – in their capacity as a source state of income, residence state of an investment fund and residence state of an investor ('triangular situation') – it is not always clear which of the states should take measures to eliminate double taxation. In this respect, a broad distinction may be drawn between the case where the fund is treated as intransparent and the

case where the fund is considered as transparent. In the case of an intransparent fund, the elimination of double taxation seems to concern only the source state and the residence state of the fund, whereas in the case of a transparent fund both the source state and the residence state of the investor are involved.[1281]

At the outset of the following assessment, it must be pointed out that the following issues are secondary to the question as whether the source state of income is prohibited under Community law – in a case where no taxes are levied on domestic investment funds on the income – from levying withholding taxes on income paid to foreign investment funds. As concluded in Chapter 7.4.2, it is likely that the source state of income is not, under Community law, entitled to levy withholding taxes in such circumstances. The issues related to tax treaties would, of course, still be of relevance, to the extent that a Member State is entitled to levy such withholding taxes – because it imposes such taxes also on domestic investment funds – and also in a case where the compatibility of tax treaties would actualise before the ECJ prior to the question of withholding taxes in the source state of income.

7.7.2 Assessment under Community Law

Eligibility for tax treaty benefits. In view of the possible impact of Community law on the tax treaty access of investment funds, the *Saint- Gobain* judgment is of particular significance. The importance of the *Saint-Gobain* case, which concerns itself with the question of whether a permanent establishment of a non-resident company is entitled to tax treaty benefits in the state of establishment, lies in the fact that some conclusions may possibly also be drawn thereform in respect of other triangular situations where the entitlement to tax treaty benefits has traditionally been in doubt.[1282]

However, at the outset of examination, a note of caution must be added as to too direct an applicability of the *Saint-Gobain* case to investment funds or their investors covered by this study. Firstly, while permanent establishments (or specifically 'branches' in terms of Community law)[1283] of non-resident

[1281] Additional problems may, of course, arise in a case where the two states involved do not agree with the classification of the fund as intransparent or transparent.

[1282] See Pistone (2002) 170, where partnerships, controlled foreign companies (CFC) and investment funds are mentioned as examples possibly affected by the *Saint-Gobain* case.

[1283] Some terminological issues may arise in this context. The Community law recognises the branch as a form of exercise of the secondary right of establishment. The branch matches for the most part with the tax law concept of permanent establishment, though there may also be exceptions. For this terminology issue, see Pistone (2002) 32. For the purposes of this study, the tax law term 'permanent establishment' is used.

companies are covered by the freedom of establishment, the activity carried out by investment funds and their investors falls under the provision concerning free movement of capital. Secondly, while the permanent establishment involved in *Saint-Gobain* was a legally dependent part of a non-resident company established in another Member State, the participants of an investment fund often reside in several different Member States and non-Member States. This raises the question of the potential applicability of limitation-of-benefits provisions, or of other anti-abuse measures targeted against treaty-shopping situations, and their compatibility with Community law, questions not raised in the *Saint-Gobain* case.

In accordance with the *Saint-Gobain* case, the Member State in which a permanent establishment is situated is obliged to extend measures for alleviating international double taxation under the tax treaty[1284] to the permanent establishment of a non-resident company resident in another Member State. This obligation, which derives from the principle of national treatment, or prohibition of non-discrimination, is conditional upon the comparability of the respective situations of the permanent establishment and resident company in the involved Member State. In view of the subject of the study, a parallel may be drawn with a hypothetical situation where there are two resident investment funds, the one being owned wholly by resident investors and the other by non-resident investors. In line with the Court's reasoning in the *Saint-Gobain* case, the Member State may not differentiate between the two situations for tax treaty purposes, provided that the situations are comparable for Community law purposes. Therefore, the state of residence of the investment fund must not differentiate between investment funds with domestic participants and those with foreign participants. However, this situation is not of general relevance in view of investment funds, since, as a rule, they are not entitled to, or cannot benefit from, the methods of elimination of double taxation as provided for in tax treaties, on account of their tax exemption.

The obligation of the Member State of the permanent establishment, to extend measures of alleviation of double taxation as provided in its tax treaties, may be referred to as a partial extension of tax treaties to permanent establishments. However, the *Saint-Gobain* judgment leaves open the important question as to whether the permanent establishment should also be entitled to other treaty benefits, such as the reduced rates of withholding taxes on dividends, interest and other types of income, as provided by the relevant tax treaty.[1285] In other words, the issue not involved in the *Saint-Gobain* case

[1284] And also, it should be added, measures provided under domestic tax law.
[1285] See Jiménez et al. (2001) 247

is the position of the *source state*. It is exactly the position of the source state, and not the residence state, which is of significance from the perspective of investment funds. As mentioned, this is because the vast majority of investment funds would not, as tax-exempted entities, actually benefit from the extension of measures aimed at alleviating double taxation as provided by tax treaties of the residence state. As a consequence, another issue of general relevance must be addressed in order to determine whether investment funds could potentially benefit from the *Saint-Gobain* judgment: Is the source state involved also obliged to extend tax treaty benefits on grounds of the national treatment requirement in the residence state?

In the case of the so-called full extension of tax treaties, the taxing right of the source state in which the permanent establishment, or the investment fund, derives income would also be affected. It is arguable that the full extension of tax treaties cannot be directly inferred from the *Saint-Gobain* judgment.[1286] On the other hand, it must also be noted that in *Saint-Gobain* the source state was not an EU Member State, and in any case the full extension of tax treaties was not one of the issues under consideration in the case.

There are some strong arguments supporting the full extension of tax treaties to permanent establishments.[1287] In particular, the national treatment of permanent establishments of non-resident companies in the Member State, under Article 43 EC, seems to require the extension of tax treaty benefits to permanent establishments not only in the residence state but also in the source state. Arguably, the permanent establishment of a non-resident company is not treated in the same way as resident companies, if it has no access to all tax treaty benefits under tax treaties concluded by the Member State. The denial of tax treaty benefits by the source state could jeopardize the national treatment of permanent establishments in the Member State in which it is situated[1288], in which case the negative Community loyalty under Article 10 EC could be invoked by the Court. It has, however, been noted that the full extension of tax treaties would at least to some extent contradict the Court’s reasoning in the *Gilly* case, that Member States are competent to determine the criteria for allocating taxing powers as between themselves.[1289]

[1286] See Offermanns – Romano (2000) 187; Lausterer (1999) 53-54.

[1287] The full extension of tax treaties by way of obligations derived from Community law can of course only take place in cases where the source state is an EU Member State, because third countries are not bound by Community law. It is argued that, in a case where a third-country source state does not allow the permanent establishment situated in the Member State to benefit from lower withholding tax under the tax treaty, the latter must compensate the double taxation caused by the source state, by way of allowing a credit up to the amount of withheld taxes. This argument is based on the requirement of national treatment of permanent establishments under Community law. See van den Hurk (2001) 157.

[1288] Jiménez et al. (2001) 248. Similarly van den Hurk (2001) 157.

[1289] Jiménez et al. (2001) 249.

In any case, the question of whether the full extension of tax treaty benefits could be required by Community law, under a situation like that in *Saint-Gobain,* becomes secondary when the application of tax treaties to investment funds is considered primarily from the source state perspective. The primary question then becomes whether Community law may affect the way in which the Member State, in its capacity as a source state, applies its tax treaties. More specifically, the source state's obligation to apply tax treaties to the foreign investment fund established in another Member State is, according to this approach, not derived from the fund's treatment for tax treaty purposes in the residence state, in respect of the income received from the source state. This is a logical approach in a case where the fund is tax-exempted in its residence state, and cannot therefore in any case benefit from tax relief as provided for by the tax treaty concluded between the source and residence state, regardless of whether the residence state applies the treaty to its investment funds or not[1290]. Moreover, in the case of tax-exempted investment funds, recourse to the national treatment requirement as in the *Saint-Gobain* case is pointless, because the application or non-application of tax treaties in the residence state is unlikely to depend on whether the units are held by resident or non-resident investors.

The question which must then arise is whether Community law may affect the source state's decision on whether to allow the investment fund to benefit from lower withholding tax rates as provided for by the relevant tax treaty. Based on the Court's reasoning in the *Gilly* case, the answer to the question seems to be negative. In the first place, the Court has accepted that the Member States are competent, in their tax treaties, to determine the criteria for taxation with a view to eliminating double taxation, although they must comply with Community law when exercising their taxing powers. The question as to whether the investment fund is entitled to tax treaty benefits seems to relate more closely to the allocation of taxing powers than to the exercise of such powers. This would leave considerable freedom for the Member States themselves to decide the criteria for tax treaty access. The denial of tax treaty benefits by the source state, on grounds that the investment fund does not meet the criteria of being a resident of a contacting state, seems therefore not to contradict Community law. Both the denial and the granting of tax treaty benefits in case of tax-exempted entities may be said to constitute

[1290] Even if the residence state were to apply the tax treaty to its investment funds, double taxation of income would not be eliminated. This results from the fact that the tax credit methods used for the purposes of eliminating double taxation of dividends and interest do not oblige residence states to grant relief in excess of taxes payable in that state by the taxpayer. Tax-exempted investment funds would benefit from tax credit only in case the taxes paid in the source state would be refunded in the residence state. As explained in Section 7.3.6, the ordinary credit method as provided for in the OECD Model Convention is compatible with Community law.

internationally accepted practices, as the OECD Model Commentary also refers expressly to both possibilities.[1291] In the wake of the adoption of the Savings Tax Directive, the transparent treatment of investment funds has, at least to a certain extent, also been recognised in the secondary Community law, though it is arguable that this is only on account of practical concerns.[1292] Moreover, as is clear from the *AMID* case, the Court has no jurisdiction to rule on the interpretation of tax treaty provisions. Therefore, the Court cannot rule on the right interpretation of Article 4(1) of the OECD Model Convention, in particular concerning the term 'liable to tax', for Community law purposes.

Limitation-of-benefits provisions. In addition to the grounds of general provisions concerning tax treaty eligibility, investment funds may be denied tax treaty benefits on grounds of limitation-of-benefits provisions. However, the compatibility with Community law of various limitation-of-benefits provisions in tax treaties concluded by the Member States is entirely unclear, since there is so far no case law dealing with the issue. Below, some conclusions on their compatibility with Community law will be drawn, in light of their impact on investment fund investments.

The investment fund may be denied tax treaty benefits in another Member State on grounds that it does not qualify as the beneficial owner of the income it receives. Should this be the case, tax treaty benefits would generally be available to underlying investors, though the exercise of such rights could be precluded by disproportional practical difficulties with foreign tax authorities, related to the refund procedure.

Generally speaking, it has been argued that the requirement of a person being a beneficial owner of the income does not, as such, infringe Community law, because it applies regardless of the nationality or residence of the recipient of the income.[1293] Besides, the recently adopted Interest-Royalty Directive[1294] and Savings Tax Directive[1295] employ the concept of a beneficial owner, though only the first-mentioned with the same anti-abuse purpose as tax treaties, that is restricting available benefits only to persons qualifying as beneficial owners.[1296]

On the other hand, the possibility that the concept of a beneficial owner of the income for tax treaty purposes might be incompatible with Community law cannot be totally ruled out, particularly in view of the restriction-based

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[1291] See Art. 4 para. 8.2 and 8.3 of the OECD Model Commentary.
[1292] Under the Savings Tax Directive, the flow-through of income to underlying investors has been recognised to the extent that the income type is concerned.
[1293] See Baker (1998) 199. See also Dibout – Offermanns (1998) 94.
[1294] Art. 3(1)(c) of the Interest-Royalty Directive.
[1295] Art. 1(1) and 2 of the Savings Tax Directive.
[1296] For the purpose of a beneficial owner in the context of the Savings Tax Directive, see Chapter 6.3.2 of this study.

approach to fundamental freedoms. From the perspective of free movement of capital, it is obvious that denial of tax treaty benefits, on grounds of the beneficial ownership is, in principle, liable to discourage foreign investment funds from investing in the Member State denying tax treaty benefits. However, to the extent that underlying investors, rather than the investment fund, were entitled to tax treaty benefits – albeit only theoretically – the discouraging effect might not be easily upheld by the Court.

Sometimes it is argued that the outcome depends on a particular interpretation of the concept by a Member State. [1297] Basically, the incompatibility with Community law would require the interpretation to lead either to unjustifiable discrimination of non-residents, or to a restriction on a fundamental freedom. It has been argued that the compatibility with Community law could be at stake where the existence of beneficial ownership is decided on the basis of economic substance of transactions, rather than on the legal ownership of the income.[1298] In other words, the beneficial ownership would serve as an anti-avoidance measure. Should this be the case, the Court would, in line with the case law concerning anti-avoidance measures, generally pay attention to whether there may be any proof of abuse on the part of tax treaty subjects[1299], and whether the source state applies equivalent measures to domestic persons[1300].

In regard to possible interpretations (legal vs. economic), it may also be noticed that, owing to the inclusion of the concept of beneficial ownership in the two above-mentioned directives, the beneficial owner has become a Community law concept. Consequently, the right interpretation of beneficial ownership may eventually be raised before the ECJ.[1301] Another point is whether the Court will be capable of ascribing to the concept any more accurate meaning under Community law than it currently has in tax treaty law. It is also not certain whether a Community law meaning would be of any significance from the perspective of tax treaties, which may call for an autonomous meaning of the term rather than a domestic one[1302]. Furthermore,

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[1297] See Hinnekens (1995) 230.

[1298] See Hinnekens (1995) 230; Kemmeren (1998b) 134. For example, a resident entity might be denied tax treaty benefits on grounds that it is owned substantially by non-resident participants, even though the entity were the legal owner of the income.

[1299] See Hinnekens (1995) 230-231.

[1300] However, it is not clear whether this would be a proper comparison, as it is arguable that the concept of a beneficial owner has its specific meaning and purpose in tax treaties, separate from any domestic tax law meaning and purpose.

[1301] See Weber (2000) 22-23.

[1302] The interpretation of the concept by the ECJ may, in principle, have impact on its interpretation for tax treaty purposes, because as part of Community law it would also be part of the domestic laws of Member States. Therefore, to the extent that domestic law may be used in interpreting the concept of beneficial ownership for tax treaty purposes, the interpretation by the ECJ would also have impact

in light of the existing case law, in particular the *Gilly* case, it seems unlikely that the Court would be willing to intervene in a Member State's decision as to who is to be considered as the beneficial owner of income for tax treaty purposes.

Investment funds may also be excluded from tax treaty benefits by way of an express exclusion clause, or indirectly, by applying a so-called holding company clause. Both the exclusions actualise most frequently in the case of Luxembourg investment funds. Generally speaking, clauses excluding tax-priviledged entities from tax treaty benefits do not seem, as such, to infringe Community law. In particular, they do not make the exclusion dependent on the nationality or residences of the persons who have established such entities[1303], though a restriction on fundamental freedoms could occur even without a display of such features. It has been noted that the exclusion of tax-exempted entities is also in accordance with the approach taken in the Parent-Subsidiary[1304] and Merger Directives[1305] in that such entities are not entitled to benefits conferred by the directives.[1306] The prevailing opinion seems to be that at least the holding company clauses in the Luxembourg tax treaties would be compatible with Community law.[1307]

However, certain reservations must at least be made when considering the compatibility of applying exclusion clauses to investment funds qualifying as UCITS. In the first place, the exclusion seems to be in conflict with the objective of the UCITS Directive, which is based on mutual recognition of investment funds across Member States. This is because an outright exclusion from treaty benefits discourages resident investors from investing into domestic securities – the income on which is subject to withholding tax – through foreign UCITS which are excluded from the scope of the tax treaty. Therefore, unlike in the case of Luxembourg holding companies, the argument – in the case of investment funds covered by the UCITS Directive – that the exclusion of tax-exempted entities is in line with the secondary Community

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on tax treaty situations. However, it seems that the prevailing opinion is that the concept has its autonomous meaning for tax treaty purposes.
According to Hinnekens (2000) 44, the concept of beneficial ownership in the directives is autonomous with respect to its minimum content, and cannot be directly interpreted from the OECD Model Convention and Commentaries. Firstly, this is because there is no express reference to the tax treaty meaning of the concept in the directives. Secondly, the concept is used with different meanings in tax treaties and directives, in that in tax treaties it serves as counteracting treaty shopping, whereas in the Community context this is not the case. See also Hinnekens (1995) 231, where he considers it important to find a Community-wide meaning for the concept of beneficial ownership for tax treaty purposes.

[1303] Baker (1998) 197.

[1304] Art. 2(b).

[1305] Art. 3(b).

[1306] See Kemmeren (1998b) 135. This, of course, does not necessarily mean that there could not be conflict with primary Community law.

[1307] See Dibout – Offermanns (1998) 94; Kemmeren (1998b) 135; Baker (1998) 197.

law does not seem valid. According to this view, holding companies also do not enjoy protection, under the right of establishment, because their activity does not qualify as an economic activity.[1308] However, in the case of UCITS investment funds, this argument does not seem valid either. It is clear that the acquisition of units of such investment funds by investors, as well as investment activity by an investment fund, are covered by Article 56 EC, so that a conflict with primary Community law is possible due to the restrictive impact of such an exclusion.

As shown in Chapter 4.4.3.4, an investment fund which is widely held by non-resident investors may be excluded from benefits, under a limitation-on-benefits provision, inserted in tax treaties concluded between Member States and the United States. By contrast, when its majority holdings are in the hands of resident investors, the same investment fund *would* be granted such benefits on the part of the United States. Generally speaking, the compatibility with Community law of the limitation-on-benefita provision is one of the most debated issues in the legal literature.[1309] Unlike the requirement of beneficial ownership, limitation-on-benefits provisions make – under certain conditions – the entitlement of entities to tax treaty benefits dependent on the residences of underlying participants. This applies particularly to the ownership test – which typically requires more than 50 per cent of the owners of the entity to be resident in the other contracting state or the United States; and to the base erosion test, requiring that a maximum of 50 per cent of profits of the entity may be paid out to participants who do not fulfill the conditions referred to earlier. Obviously, in a case where the majority of participants of a resident entity are residents of other Member States, both requirements are liable to discriminate against such foreign-held entities, and also to discourage non-residents from investing in such resident entities.

The condition that the majority ownership of an investment fund must be in the hands of resident investors, in order for it to qualify for tax treaty benefits, in accordance with the *Saint-Gobain* case, as such discriminates against resident investment funds the majority ownership of which is in the hands of residents of other Member States. Generally speaking, there seems to be a broad agreement that the ownership and base erosion tests are incompatible

[1308] See particularly Kemmeren (1998b) 135.

[1309] Another highly debated issue, which is whether the most-favoured-nation (MFN) principle can be derived from Community law for tax treaty purposes, will not be discussed here. The application of the MFN principle for tax treaty purposes would mean that Member State A should extend treaty benefits provided in the tax treaty between Member States A and C also to a resident of Member State B if the first-mentioned treaty contains more favorable benefits than the tax treaty between Member States A and B. For the MFN principle in the context of tax treaties, see Vogel et al. (1997) 1285-1286. The prevailing opinion seems to be that the MFN principle cannot be derived from Community law. See Vapaavuori (2003) 278–282; Ståhl – Österman (2000) 138-139; Hinnekens (1995) 209-215.

with Community law but only if considered in isolation from other stipulations of a limitation-on-benefits provision.[1310] It has been pointed out that, owing to the inclusion of the activity test in a limitation-on-benefits provision, only those entities whose activities are more of a passive nature will actually be excluded from tax treaty benefits.[1311] However, even if one accepts that fundamental freedoms are applicable only in the case of active business, in contrast to passive[1312], it is doubtful whether the concept of active business in limitation-on-benefit provisions coincides with that of Community law.[1313] This is the case also in view of investment funds. As stated in Chapter 4.4.3.4, investment funds cannot rely on the active business test, yet they are protected by primary and secondary Community law.

The compatibility of a limitation-on-benefits provision with Community law is also dependent on the general question of the compatibility of anti-abuse provisions with Community law.[1314] In line with the case law, anti-abuse provisions are allowed to the extent that they cover only abusive cases, though the exact meaning of abuse under Community law is more or less unclear.[1315] Limitation-on-benefits provisions typically contain a so-called subjective clause, according to which tax authorities of the source state have discretionary powers to grant treaty benefits in non-abusive cases, even if a person fails to satisfy any other tests of the provision. As has been earlier submitted in this study, UCITS investment funds – as widely held entities – cannot practically be used for abusive purposes such as treaty shopping, in which case they should be granted tax treaty benefits under the subjective clause, in order to avoid a conflict with Community law. However, whether this could be the case is eventually in the hands of US tax authorities and cannot be answered here. In any case, it suffices to state that the ECJ has not considered it sufficient, for Community law purposes, that tax authorities are granted only discretionary powers to remedy cases constituting violation of

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[1310] See, for example, Scherer (1995) 143-148; Mössner (1998) 106; Vapaavuori (2003) 284. See also Terra – Wattel (2001) 113 and references there. Another test, typically included in a limitation-on-benefits provision, is the stock exchange test, according to which resident companies listed on a recognised stock exchange are entitled to tax treaty benefits. It is often the case that not all stock exchanges of Member States are recognised within the meaning of a provision. Therefore, resident companies listed on a non-recognised stock exchange of a Member State would be discriminated against those listed on a recognised one. See for a more detailed discussion, Kemmeren (1998b) 137-138.

[1311] See Mössner (1998) 106.

[1312] It is not clear that passive companies are protected by the the right of establishment. See Kemmeren (1998b) 142. One could, however, assume that the free movement of capital would nevertheless remain applicable. See Prechal (1998) 10, particularly footnote 43, according to whom it is not entirely clear whether the requirement of genuine economic activity attributed by the ECJ to the exercise of the right of establishment is applicable in the context of other freedoms.

[1313] See Kemmeren (1998b) 142.

[1314] Vapaavuori (2003) 285.

[1315] See discussion in Chapter 7.3.3.

Community law; rather, there must be a legal obligation to do so. This clearly is not the case for a limitation-on-benefits provision, where it is up to the US tax authorities to determine the standard of an abuse of tax treaties and consequently to allow or to deny tax treaty benefits.[1316] Moreover, the need for a subjective clause may be held in itself as evidence that contracting states expressly recognise the further potential applicability of the provision to cases not constituting abuse of a tax treaty. As the matter is not one between two Member States but between a Member State and a third country not bound by Community law, the consequences of the possible breach of Community law as well as its remedies are, however, not straightforward.[1317]

France has agreed, in tax treaties concluded with certain other Member States, on arrangements under which withholding taxes at source are refundable, in the case of an investment through an investment fund, with reference to the proportion of resident investors of the investment fund. To the extent that underlying investors are not resident in the same state as the investment fund no refund is available. At first sight the same doubts seem to arise, from the Community law perspective, as in the case of the ownership test in connection with a limitation-on-benefits provision. A distinction between investment funds on the basis of the residence of underlying investors amounts to covert discrimination of investment funds owned by residents from other Member States. However, the disadvantage caused by the distinction is in practice reduced by the fact that the benefit of refund is typically allocated between all investors, whether resident or non-resident. Nonetheless, it is still possible to argue that such a distinction would be liable to discourage investment funds from providing services for non-resident investors if this were to result in a higher level of withholding taxes. Though the causal relationship between the proportion of resident and non-resident investors and

[1316] See Toifl (1998) 82, who considers it unlikely that the US tax authorities would commit themselves to remove any discrimination or restriction in the sense of Community law following from a limitation-on-benefits provision.

[1317] It has also been pointed out that the discriminative or restrictive effect of limitation-on-benefits provisions results essentially from the United States denying treaty benefits at source rather than from its treaty partner, which has only agreed to a measure which is liable to cause such a effect. See Mössner (1998) 106. Toifl (1998) 83-84 goes a step further by concluding that the discrimination is due to US domestic law rather than to limitation-on-benefits provisions in tax treaties, because the United States could, even in the absence of a limitation on benefit provision, deny tax treaty benefits unilaterally. On the other hand, Kemmeren (1998b) 146-147, footnote 118, is sceptical towards this argument.

In any case, the Member State involved would be obliged, depending on whether the treaty was concluded before or after the date of entry into force of/or the date of accession to the EC Treaty, either to try to renegotiate the treaty or to eliminate the incompatibility caused by the provision with Community law. See Terra – Wattel (2001) 112-114, who nevertheless raise doubts whether action on the part of the involved Member State could be succesful in view of the fact that the United States would not be bound by Community law. They also doubt whether a Member State could be held liable for damages caused by the application of a limitation-on-benefits provision.

the fund's investment policy is distant, it is safe to conclude that, from the perspective of Community law, any distinction between resident and non-resident investors is suspect to scrutiny by the Court. Therefore, to be clearly compatible with Community law, non-resident investors residing in other Member States should at least be equated with resident investors for the purposes of the provision.

7.8 Conclusions

Despite the absence of judgments by the ECJ in the field of taxation of investment funds and their investors, there is no doubt that negative integration has already had a significant impact on national tax measures in that field. In many Member States, tax measures which have been likely to conflict with Community law have recently been abolished. Nonetheless, the assessment made in this chapter, with respect to several tax measures across the selected Member States, has demonstrated that measures which are likely to conflict with Community law are still applied. On the other hand, it must be conceded that the most outright examples of EC-incompatible national tax measures have disappeared in the wake of the abolition of the German AuslInvestmG.

The results of the assessment are summarized in the following table. The degree of incompatibility, or compatibility, respectively is evaluated on a scale comprising 'with near-certainty', 'probably' and 'depending on circumstances'. The table serves only as guidance on the achieved results of the assessment in the chapter. On account of many 'ifs and buts' as regards the Court's possible interpretation and application of Community law to a certain national measure, any further-reaching conclusions should be drawn only after reading the full assessment made earlier in the chapter.

Table 14. Summary of Assessments Made in Chapter 7.

Measure	Compatibility with EC law
Withholding taxes at source on income paid to a foreign investment fund	- -
Confinement of imputation credit to domestic fund investments (UK)	- -
Confinement of tax allowance and *avoir fiscal* to domestic fund investments (FRA)	- -
Methods of crediting foreign withholding taxes in the context of investment fund investments (GER)	+ +
Methods of crediting foreign withholding taxes in the context of investment fund investments (FRA)	- -
Offshore funds legislation (UK) - tax reporting - tax sanctions - procedural aspects, uncertainty etc.	 + + + -/+
Investmentsteuergesetz (GER) - tax reporting - tax sanctions - procedural aspects, uncertainty etc.	 + + - - -/+
Withholding taxes at source on income paid to a non-resident fund investor	-/+
Denial of imputation credit to non-resident fund investors (UK)	++
Denial of the half-income system to non-resident fund investors (GER)	-/+
Denial of the annual allowance to non-resident fund investors (GER, FRA)	-/+
Tax treaties - eligibility for tax benefits - limitation-of-benefits	 + -/+

+ + = no conflict with near-certainty
+ = no conflict probably
- - = conflict with near-certainty
- = conflict probably
+/- = depending on circumstances

The impact of negative integration has not always been endorsed among the legal scholars, let alone among the Member States. The basic problem is seen to be that the Court cannot build anything new to replace the national rules

which it has declared to breach Community law.[1318] As shown in this chapter, typical national measures resulting in the likely infringement of Community law are those which restrict certain tax benefits only to resident investors of domestic investment funds, whereas investors participating in foreign investment funds are excluded from such benefits. Once banned by the ECJ, the concerned Member State obviously confronts two alternative courses of action: either it may take unilateral action by extending such benefits to resident investors of foreign investment funds, or it may abolish such benefits altogether.

Here a parallel may be drawn with imputation systems whose EC-compatibility is seriously at stake. At the present time, several Member States have abandoned, or are about to abandon, such a system, whereas none of the Member States have extended imputation credits unilaterally to cross-border investments. However, in the area of investment fund investments, an opposite development can also be pointed out: Germany extended the possibility of benefiting from tax credits to German investors of foreign investment funds. The rationale for this must be that Germany did not wish to abandon its long-standing approach of taxing investment fund investments in accordance with the principle of transparency, in the face of a likely incompatibility of the previous tax regime with Community law. As a result, it took unilateral measures to protect the EC-compatibility of its tax regime. It remains to be seen whether France (apart from the *avoir fiscal* system which will be abolished as of 2005) and the United Kingdom will react in the same way, or whether they choose to abolish the existing tax benefits. However, it is likely that any action on their side may require a response from the Commission and possibly litigation before the ECJ.

Whereas in the case of an extension of tax benefits, it is possible for Member States to bring national tax measures into line with Community law requirements with relative ease, this is not the case with regard to the prevailing practices of imposing withholding taxes at source, on income paid to foreign investment funds. In that regard, a potentially more controversial choice must be made, between extending the tax to domestic investment funds, or, alternatively, totally abolishing any withholding taxes at source, when the recipient is a foreign investment fund established in another Member State. Clearly, for the majority of the Member States, the choice of the former alternative would require a U-turn in the tax policy governing investment funds and their investors, this being currently based on a tax exemption of domestic investment funds. On the other hand, neither can the second

[1318] See, for example, Williams (1997) 9, who states: "[The Court] has no power to create anything to put in place of the systems whose fairness it is unbalancing […]".

alternative be carried out without significant consequences from the perspective of the Member States. For the time being, and, as a rule, most Member States treat non-resident portfolio investors who are subject to unlimited tax liability in the same way, as far as taxation at source is concerned, and this applies equally to individuals, companies and investment funds. The exemption of only one category of non-resident portfolio investors, namely investment funds, would change the relative taxing situations of the different categories of portfolio investors, in view of their liability to withholding taxes in the source state of income.

Despite being an effective tool, tax policy exclusively based on negative integration may have negative effects, not only on national tax systems but also on the objectives pursued by the EC Treaty, and these must be noted.[1319] In view of the objective of achieving a functioning and competitive single market, a total abolition of tax benefits or of withholding taxes, without replacement measures, may run counter to the objective. The same would apply to national anti-avoidance measures which, at least to a certain extent, may conflict with Community law. Therefore, a more comprehensive, multilateral approach covering all Member States would perhaps be needed, to accommodate national tax rules to the objective of an efficient and competitive functioning single market for investment funds, without any infringement of Community law. In the following chapter, the possible enhancement of this objective through measures of positive integration will be discussed.

[1319] Prats (2002) 141. See also Lehner (2000b) 12, who considers that the internal market cannot be produced by only interpreting the EC Treaty.

8 TAXATION OF INVESTMENT FUND INVESTMENTS AND POSITIVE INTEGRATION

8.1 Introduction

Positive integration refers to the approximation of national laws between Member States through legislative measures taken at a Community level.[1320] In accordance with Article 249 EC, the Community institutions may issue legal acts (Community acts) binding Member States: Community acts are referred to as secondary Community law.

Direct taxes are hardly mentioned in the EC Treaty. However, the Treaty does contain general provisions on the harmonization and approximation of the laws of Member States, insofar as these affect the establishment or functioning of the internal market (Articles 94 and 95 EC). Owing to the absence of any specific rules in the EC Treaty concerning direct taxation, the basis for the positive measures in the field of direct taxes is the general provision of Article 94 EC, on directives for the approximation of Member States' laws, regulations or administrative provisions which directly affect the establishment or functioning of the common market.[1321] In accordance with Article 94 EC, the Council must act unanimously on a proposal from the Commission, and after consultation with the European Parliament and the Economic and Social Committee. Article 95(2) EC expressly provides that the qualified majority procedure as provided for by Article 95(1) is not applicable in tax matters.[1322]

Under Article 94 EC only directives, but no other binding measures, may be issued.[1323] In most cases, the requirement of unanimity has proven to be a major obstacle to the adoption of directives in the field of direct taxation. For a long time, only two directives on direct taxation had been adopted under

[1320] See Terra – Wattel (2001) 22.
[1321] The article uses the word 'approximation' instead of 'harmonization', which is sometimes interpreted as meaning a lighter enactment that aims at coordinating different laws rather than harmonising them. See Penttilä (1996a) 240. However, it seems that the terminology in this respect is not very settled. See, for example, Hinnekens (1997) 42-45, who distinguishes between unification, approximation and coordination in terms of their degree of intensity.
[1322] Art. 95(2) EC.
[1323] For different types of Community acts and their legal effects, see Hartley (1998) 99.

Article 94 EC, the one dealing with cross-border dividends between affiliated companies (the Parent-Subsidiary Directive)[1324] and the other with cross-border mergers (the Merger Directive)[1325]. Recently, two additional directives were adopted by the Council, the one concerning interest and royalty payments between affiliated companies (the Interest-Royalty Directive)[1326] and the other concerning the taxation of interest on portfolio savings (the Savings Tax Directive). Of the directives, only the Savings Tax Directive is generally applicable to investment funds and their investors, as discussed earlier in the study.

In addition to the general rules of harmonization, Article 96 EC provides a legal basis for the Commission to take necessary action to eliminate market distortions caused by differences between domestic laws of Member States. In contrast to Article 94 EC, Article 96 EC allows the adoption of directives by a qualified majority. Article 96 EC is thus considered as a safety valve which enables the Community to handle market distortions without being paralysed by the unanimity rule.[1327] To date, this article has had no significance in the tax policy of the Community, though the Commission has repeatedly referred to the possibility of relying on it even in direct tax matters.[1328]

An alternative to positive action at the Community level is intergovernmental co-operation between Member States.[1329] The result of intergovernmental co-operation is intergovernmental conventions, to which bilateral and multilateral tax treaties bear most relevance in the direct tax area. Article 293 EC provides that Member States shall, so far as is necessary, enter into negotiations with each other with a view to securing, for the benefits of their nationals, the abolition of double taxation within the Community.[1330] In contrast to Article 94 EC, the measures taken on the basis of Article 293 EC do not constitute secondary Community law but multilateral international

[1324] Council Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ L 225, 20/08/1990 p. 6-9.
[1325] Council Directive 90/434/EEC on the common system of taxation applicable to mergers, division, transfer of assets and exchanges of shares concerning companies of different Member States, OJ L 225, 20/08/1990 p. 1-5.
[1326] Council Directive 2003/49/EC on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, OJ L 157, 26/06/2003 p. 49-54.
[1327] Terra – Wattel (2001) 17.
[1328] See Terra – Wattel (2001) 17. Recently, the Commission referred to Art. 96 EC in its communication concerning tax policy in the EU. See COM(2001) 260 final, p. 22.
[1329] See Jiménez (1999) 171.
[1330] In accordance with its wording ("so far as is necessary"), Art. 293 EC is considered to be of complementary character and to be used only if other legal basis such as Art. 94 EC do not suffice to prevent double taxation. See Terra – Wattel (2001) 13 and 406. In particular, this is the view of the Commission. However, there is also an opposite interpretation according to which only the Member States are addressed by Art. 293 EC with a consequence that only the Member States have the power to take measures as referred to in that article. For this view, see Lehner (2000b) 5-6.

public law conventions.[1331] Consequently, the ECJ has no competence in enforcing the provisions of measures taken on the basis of the article, nor do such measures have of themselves direct effect on, and precedence over, national law.[1332] In any event, the importance of the article has so far been limited, and it has served as a basis for only one agreement between Member States, namely that concerning arbitration in transfer pricing disputes (The Convention on Arbitration in Transfer Pricing Disputes).

In the face of the Council's difficulties in reaching any agreements in the field of direct taxation, the Commission is increasingly taking a more active role in removing tax obstacles to the smooth functioning of the internal market. Besides proposing directives and initiating infringement procedures, the Commission intends to avail itself increasingly of a variety of non-legislative Community measures, including communications, recommendations, guidelines and interpretive notices.[1333] Although this type of 'soft law' measures have no legal binding force, the ECJ may use them as one source of law when interpreting Community law. In this way, they may have a certain influence on case law.[1334] Moreover, by way of soft law measures, the Commission can provide guidance to Member States on the application of the EC Treaty principles in the field of direct taxes, and can contribute to the development of new EC-compatible tax rules.[1335] Recently, the Commission has taken the soft law approach on the tax obstacles to cross-border occupational pensions.

Finally, the principle of subsidiarity must be addressed. According to Article 5(2) EC the Community shall take action only insofar as the objectives of the proposed action cannot be sufficiently achieved at the level of the Member States and can therefore be better achieved by the Community. Therefore, the principle of subsidiarity limits the action by the Community in so far as the same effect could be achieved at the national level of the Member States. As regards the action taken by the Community, the principle of proportionality enshrined in Article 5(3) EC further limits it, so that it shall not go beyond what is necessary to achieve the objectives of the EC Treaty.[1336] In practice, it is not however clear to what extent the principle of subsidiarity could limit the adoption of secondary Community law.[1337] In the view of the

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[1331] Terra – Wattel (2001) 407.

[1332] In this case, the direct effect on and precedence over national law will generally depend on the constitutional law of each Member State. See Terra – Wattel (2001) 407.

[1333] See COM(2001) 260 final, p. 23.

[1334] See Terra – Wattel (2001) 15.

[1335] See COM (2001) 260 final, p. 23. The Commission, for example, issued recommendations on the taxation of non-residents and on the tax treatment of small and medium-sized enterprises in 1994.

[1336] For the interaction between the subsidiarity and proportionality principles, see Pistone (2002) 12-13.

[1337] See Hartley (1998) 111-113.

Commission, there is need for a certain degree of coordination of national tax systems, particularly in the direct taxation of mobile tax bases.[1338] Such coordination is necessary insofar as the differences in tax measures applied by Member States threaten the proper functioning of the internal market.[1339] Therefore, coordination, or harmonization, of tax systems is not a goal in itself but an instrument.[1340]

In relation to possible measures of positive integration – whether Community acts or other agreements between Member States – with the objective of enhancing a functioning single market for investment funds, the discussion in this chapter divides into two parts. Firstly, the significance of selected tax policy objectives from the perspective of a single market for investment funds will be discussed. The objective of the discussion is to present the most important issues to be considered when evaluating available measures of positive integration. Secondly, possible solutions to the most important taxing problems identified in the previous chapter, which could be effected through positive measures of whatever form, are considered.

8.2 Tax Policy Objectives in the Single Investment Funds Market

8.2.1 Tax Neutrality

8.2.1.1 General Considerations

National considerations. In terms of economics, tax neutrality is desirable because capital is then allocated, in accordance with economic efficiency, to its most productive use, and welfare will thus be maximized. A tax measure is said to be neutral if it does not distort economic decisions made by investors.[1341] With respect to savings and investment decisions, there are two ways in which a tax measure may be assessed in terms of its neutrality. Firstly, a tax measure may have impact on the level of savings.[1342] In other words, the choice of an investor either to consume or to save the income may be affected

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[1338] See COM(2001) 260 final, p. 9.

[1339] See, for example, COM(97) 495 final, para. 8 stating: "Achieving a properly functioning Single Market remains an overriding priority for Community action in the field of taxation." Recently, this view was restated in COM(2001) 260 final, p. 24.

[1340] See, for example, Grau – Herrera (2003) 30.

[1341] See, for example, Musgrave – Musgrave (1989) 279 ff.; Tikka (1990) 47. Tax neutrality may be defined in many different ways depending on the viewpoint taken. For them, see, for example, Ranta-Lassila (2002) 32-33; Ylä-Liedenpohja (1992). It is arguable that tax laws never will be completely neutral. Yet to the extent that economic efficiency is aimed at, a high degree of neutrality should be sought. See Vogel (1988) 310.

[1342] OECD (1994a) 45.

by the tax measure. While it may be noted that this issue has turned out to be extremely controversial in light of empirical studies[1343], it nevertheless is not of interest in view of the subject of this study.[1344]

The second way in which a tax measure may affect savings decisions is the allocation of savings between different investment objects. For an individual investor, there are available a wide variety of investment alternatives which broadly differ in three ways: the level of risk, the expected rate of return and liquidity. When making an investment, an investor confronts what is known in the field of finance as the portfolio selection problem. In making portfolio selection, the investor is faced with two conflicting objectives which must be balanced against each other. On the one hand, the investor seeks to maximize the expected return[1345], but on the other hand he wants to minimize the risk[1346] related to future returns of the selected portfolio of assets. The relationship between return und risk is usually positive: The higher the risk level of an instrument or a portfolio, the higher the expected return on it, and vice versa. As regards the third determinant, that is liquidity, the investor usually prefers the more liquid instrument to a non-liquid instrument.[1347] In the face of the difficulty of portfolio selection, many individuals prefer to rely on financial intermediaries such as investment funds.

Allocational neutrality between financial assets requires an investor's choice of particular assets to be independent of tax considerations. Owing to the fact that different forms of financial assets are close substitutes, the different tax treatment of assets is likely to have a substantial impact on the investor's choice between them. Where tax neutrality prevails, the choice between different assets – made on the basis of their expected pre-tax returns – should not be affected by post-tax return considerations.[1348]

However, the difficulties in achieving allocational neutrality are substantial, even if considerations are restricted to the impact of income taxes. To assess the overall impact of income taxes on investment decisions, one must take into

[1343] OECD (1994a) 39-41; Sørensen (1992) 317.

[1344] For example, the rate at which capital income is taxed in a residence state of an investor may have effect on his willingness to save income. Of course, the willingness to save also affects indirectly the amount of money placed into investment funds. However, in the context of the Community, the rate at which capital income is taxed, and thus also the question of the level of savings by residents, generally is, in accordance with the principle of subsidiarity, a matter for each Member State to decide. In particular, the rate at which capital income is taxed in the Member State does not generally affect the functioning of the single market, insofar as no distinction is made between domestic and cross-border investments, or between resident and non-resident investors.

[1345] See Sharpe et al. (1995) 174-177.

[1346] See Sharpe et al. (1995) 177-183.

[1347] Liquidity and the expected rate of return and risk are also closely related. A less liquid instrument generally bears a higher risk and thus should yield a higher expected rate of return, and vice versa.

[1348] See OECD (1994a) 46.

account the tax treatment of different assets at the moment of acquisition[1349], during the holding period[1350], and finally at the time of disposal.[1351] Moreover, the tax treatment of financial intermediaries may exert an influence on whether an individual wishes to hold instruments directly or through an intermediary. Whichever the case, non-neutral tax treatment is liable to divert investments from assets which offer the highest *pre*-tax rates of return into the assets that are less productive but produce greater *post*-tax returns.

International considerations. International tax neutrality considerations typically focus on the optimal allocation of capital between different states, rather than between different types of financial assets. In the absence of other barriers, investors would make a cross-border investment if the return of such an investment exceeds the return of a corresponding domestic investment. Apart from that, cross-border investments may be beneficial in that they facilitate a more efficient diversification of portfolios than purely domestic investments.[1352]

In an international context, the question arises as to what is the proper basis for neutral taxation, thereby promoting an efficient allocation of capital in international capital markets. There are two prevailing principles, namely ’capital export neutrality’ and ’capital import neutrality’, which may be used when determining tax policy with respect to international capital flows. Both principles have their own rationale and implications for how the tax treatment should be arranged.

Capital export neutrality (CEN) takes the taxation in the residence state of the investor as the starting point. CEN is said to prevail when cross-border investments are taxed in the same way as domestic investments. In other words, an investor would be indifferent to tax considerations in the choice between whether to invest cross-border or within national borders. Therefore, CEN reflects the objective that tax treatment should not have an influence on investors’ decisions as to where they invest. In an integrated capital market, free movement of capital should, in theory, equalize pre-tax rates of return across the countries if CEN prevails. In such a case, the allocation of investments will be optimal.[1353]

[1349] For example, income invested in certain instruments may be exceptionally deductible for tax purposes. This is often the case in respect of contributions to private pensions or life assurances.

[1350] For example, certain types of investment income may be treated favorably for tax purposes. This may follow either from a specific tax relief granted to an instrument, or from the overall tax regime which treats various types of income (dividend, interest, capital gains) differently. Often investment income, such as dividends and interest income, is taxed yearly in the hands of investors, whereas capital gains are taxed only when realized.

[1351] See OECD (1994a) 55.

[1352] Sørensen (1992) 315.

[1353] See OECD (1991) 39; Ruding Report (1992) 36-37; Ståhl (1996) 93-94.

In terms of taxation, CEN is based on the principle of worldwide taxation, or residence state taxation. In accordance with this principle, the residence state coordinates the neutrality of tax treatment of investments made by the investor. CEN would prevail if the exclusive taxing right of income were to belong to the residence state. However, this is not generally the case since, in accordance with the OECD Model Convention, the taxing right of dividends and interest income derived from portfolio investments is often divided between the residence state and the source state. Yet, the OECD Model Convention also allows the exclusive taxing right of such income to be allocated to the residence state of the investor. The taxation of capital gains from portfolio investments in movable property is generally based on the sole taxation in the residence state of the investor.

It is also possible to achieve CEN even if the source state taxes income. Generally speaking, three conditions must be met by the tax provisions applied to the taxation of foreign-source income in the residence state of the investor. First, foreign-source income should not be exempted from taxation, and nor should it be possible to defer the tax on cross-border income. Second, the tax base – as well as the tax rate applicable to cross-border income – must correspond to those applied to domestic-source income. Finally, the residence state must allow a full tax credit in respect of foreign withholding taxes paid at source, with the consequence that foreign taxes can be completely offset against domestic taxes. The importance of the method under which foreign taxes are credited is underscored in situations where the withholding tax rate exceeds the tax rate levied on the same income, or where the investor is even exempted from taxes[1354], in the residence state. This being the case, the foreign withholding taxes levied on the income should be refunded to the investor insofar as they exceed the amount of taxes, if any, payable on the income in the residence state. Hence, the ordinary credit method, which restricts the amount of creditable foreign taxes to the amount of tax payable on foreign-source income in the residence state, does not fully meet the condition of CEN.[1355]

Capital import neutrality (CIN) requires the taxation of investors in a state of investment, that is the source state of income, to be the same irrespective of whether investors are residents or non-residents. In effect, CIN entails the principle of non-discrimination in that non-resident investors must not be placed at a competitive disadvantage as compared to resident investors. In an integrated capital market where CIN prevails, free movement of capital would

[1354] The same applies if the investor evades taxes in the residence state.
[1355] See Ruding Report (1992) 36-37; Ståhl (1996) 94-95.

tend to equate the post-tax rates of return across the jurisdictions. In such a case, an efficient allocation of savings across countries would be ensured.[1356]

CIN is based on the principle of source state taxation, or territorial taxation. In accordance with this principle, the source state of income coordinates the equal taxation of resident and non-resident investors. CIN would be achieved when the source state has the taxing right on income arising within its borders, irrespective of whether the investor is resident or non-resident. Similarly to CEN, the implementation of CIN requires that the tax treatment of income should fulfill certain conditions. First, the state of income must have the taxing right on all the income arising within its territory. Second, the tax rules applied to such income by the source state should not discriminate between resident and non-resident investors. Third, it is required that the residence state of a non-resident investor exempts foreign-source income from taxation. In particular, the tax rules applied in the residence state of a non-resident investor should not have any impact on the tax treatment of capital income arising within the source state. Hence, only full exemption, in contrast to the exemption method with progression or any credit method, should be applied by the residence state.[1357]

An effective allocation of both savings and investments across jurdisdictions would require the existence of CEN and CIN simultaneously. This would be the case if marginal effective tax rates on investment income were identical across the states. In reality, this is not the case. As a result, a choice generally has to be made as to whether it is the aim of tax policy to pursue CEN or CIN. From an economic perspective, the choice must therefore be made as to whether an effective allocation of savings (i.e. CIN), or that of investments (i.e. CEN), takes priority.[1358]

As regards the taxation of portfolio investments, the prevailing opinion is that CEN is preferable to CIN as a tax policy objective.[1359] This is mainly supported by arguments related to economic efficiency.[1360] However, there is also a strong argument for pursuing CIN, as this facilitates competition neutrality ('a level playing field') between residents and non-residents operating on the same market.[1361] It may well be, however, that this argument

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[1356] See OECD (1991) 40; Ruding Report (1992) 35-36; Ståhl (1996) 103-105.

[1357] See Ruding Report (1992) 35-36; Ståhl (1996) 106.

[1358] See OECD (1994a) 174; Ruding Report (1992) 34-35.

[1359] See OECD (1991) 40; Ståhl (1996) 112. See also Vapaavuori (1991) 53.

[1360] In the first place, the impact of an efficient allocation of savings on economic welfare is more unclear than that of an efficient allocation of investments. In the second place, the responsiveness of savings, or the elasticity of savings, to post-tax rates of return is less, or at least more unclear, than that of investments. In other words, the absence of CEN would have more severe effects on economic welfare than the absence of CIN. See Ståhl (1996) 112.

[1361] This is because, under the principles of CIN, the source state has the exclusive taxing right on income arising within its borders, and the taxation does not discriminate between local and foreign

has more relevance to direct investors than to portfolio investors. In particular, CIN would ensure the ability of non-resident companies to compete with resident companies, or with companies from other countries, in a certain market under the same conditions as far as their taxation is concerned. In view of portfolio investors, this line of reasoning has not been considered valid.[1362] On the other hand, a more favorable tax treatment of resident portfolio investors may lead to a segregation of national capital markets. This could happen if the more favorable tax treatment of domestic investors is capitalized in the market prices of securities. In such a case, resident investors are, owing to more favorable tax treatment, willing to pay a higher price for (tax-favored) securities than are foreign investors, which may then in effect be forced out from a national capital market.

Apart from economic considerations, one has to take into account the administrative difficulties relating to CEN and CIN respectively. In the first place, CIN with source-based taxation is easier to enforce than CEN with residence-based taxation.[1363] This results from the different possibilities, of the source state and the residence state tax authorities respectively, for obtaining the information needed for tax purposes. In particular, the realisation of CEN depends crucially on resident taxpayers' voluntary declaration of cross-border income, and on the exchange of tax relevant information between tax authorities. CIN is easier to effect owing to the fact that the income arises within the national borders. As a result, inefficient enforcement of taxation may, in practice, lead to deviations between the tax policy objective of achieving CEN and the actual outcome of taxation.[1364]

Moreover, tax credit mechanisms employed in the residence states of investors do not generally provide for sufficient elimination of foreign withholding taxes. This is clear in the case of tax-exempted entities. However, even if the foreign withholding tax does not exceed the tax liability on the same income in the investor's state of residence, there are several restrictions as regards the maximum amount that can effectively be credited. As a consequence, CEN may not, in practice, be attained.[1365]

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companies. In contrast, under the principles of CEN, taxation of non-residents would be eventually determined in accordance with the tax rules applied by their residence states. As a result, non-residents from the high-tax jurisdictions would find themselves at a competitive disadvantage compared to residents and non-residents from countries with a lower level of taxation.

[1362] See Ståhl (1996) 104.

[1363] See Ståhl (1996) 127

[1364] See Vapaavuori (1991) 59.

[1365] See Vapaavuori (1991) 59-60.

8.2.1.2 Direct Investment vs. Investment Fund Investment

In the context of investment funds, tax neutrality is traditionally understood to mean that an underlying investor of an investment fund should be treated for tax purposes as if he held the same securities directly. As shown earlier, jurisdictions generally aim to ensure that the tax burden on the underlying investor of an investment fund would not be substantially greater or smaller than that resulting from a direct portfolio investment in the same securities.[1366] In other words, national tax regimes aim to reach allocational neutrality between direct investments (shares, bonds etc.) and fund investments (fund units). Yet there is the alternative view, based on the effect of substitution of securities, according to which the case for neutrality between direct and fund investments may be questioned.[1367]

The tax rules necessary to ensure tax neutrality between direct (non-intermediated) investments and fund (intermediated) investments, and also the complexity of such rules, will depend on the general tax regime applicable to capital income. The main considerations (‘C’) arising when tax neutrality is pursued in the purely domestic context, and the means (‘M’) to achieve it are generally the following:

[1366] See also OECD (1977) 5; OECD (1999) 49.
[1367] See discussion in Chapter 3.2 of the study.

A) C: Elimination of double taxation of income.
M: Tax exemption at the fund level or credit at the investor level.
B) C: Channelling of reliefs (imputation credit exemptions etc.) attached to income.
M: Flow-through of income.
C) C: Prevention of deferral of income.
M: Deemed distribution.
D) C: Application of the same tax rates.
M: Flow-through of income.

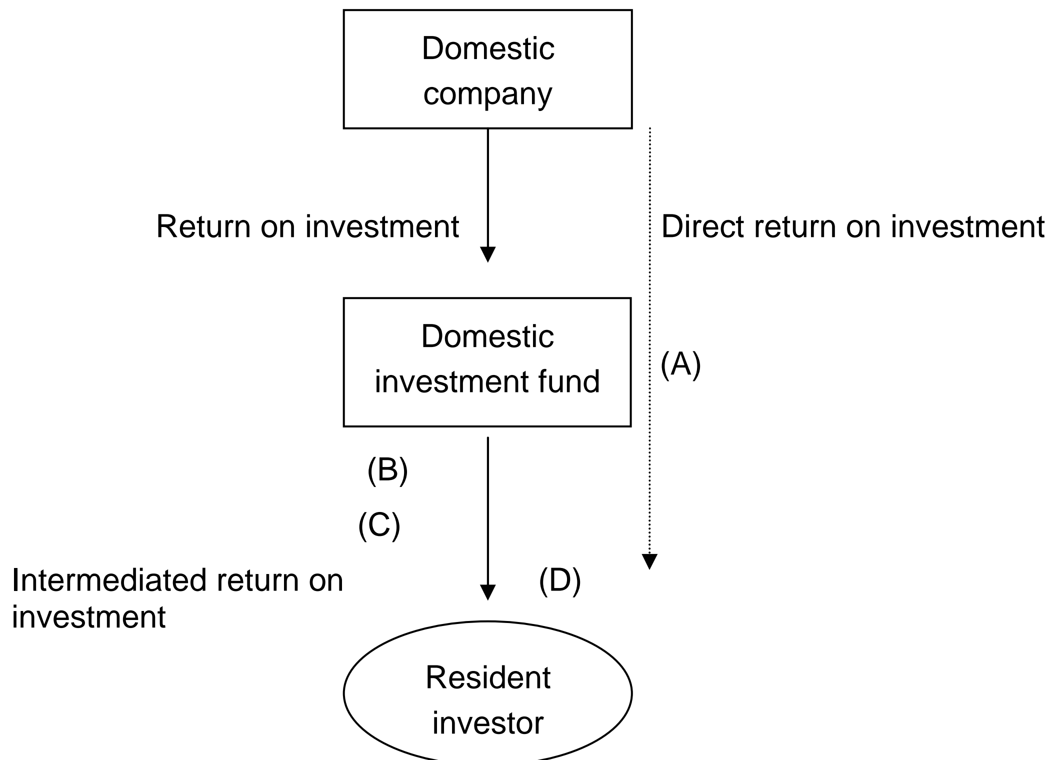

Figure 5. Tax Neutrality Considerations in the Domestic Context: Direct Investment vs. Investment through a Domestic Fund.[1368]

When pursuing neutrality between direct investments and fund investments in the case of cross-border investments, an additional set of considerations has to be brought into the discussion. This stems from the source state's entitlement to tax income by way of levying withholding tax on income arising within its territory. While in the domestic context the tax treatment of investment funds and their investors may be integrated solely through domestic measures – for example, by way of exempting investment funds from withholding taxes – this is not possible in the cross-border context.[1369] The main additional considerations arising when tax neutrality is pursued ('C'),

[1368] Adapted from OECD (1999) 48.
[1369] See OECD (1977) 5.

and means to achieve it (‘M’), in the cross-border context, are generally the following:

E) C: Withholding tax rates at source on income paid to the investment fund (E) and the direct investor (E’) respectively.
M: The investment fund or the fund investor must be entitled to tax treaty benefits similarly to the direct investor.

F) C: Foreign withholding taxes paid by the investmest fund.
M: A credit either at the investment fund or investor level.

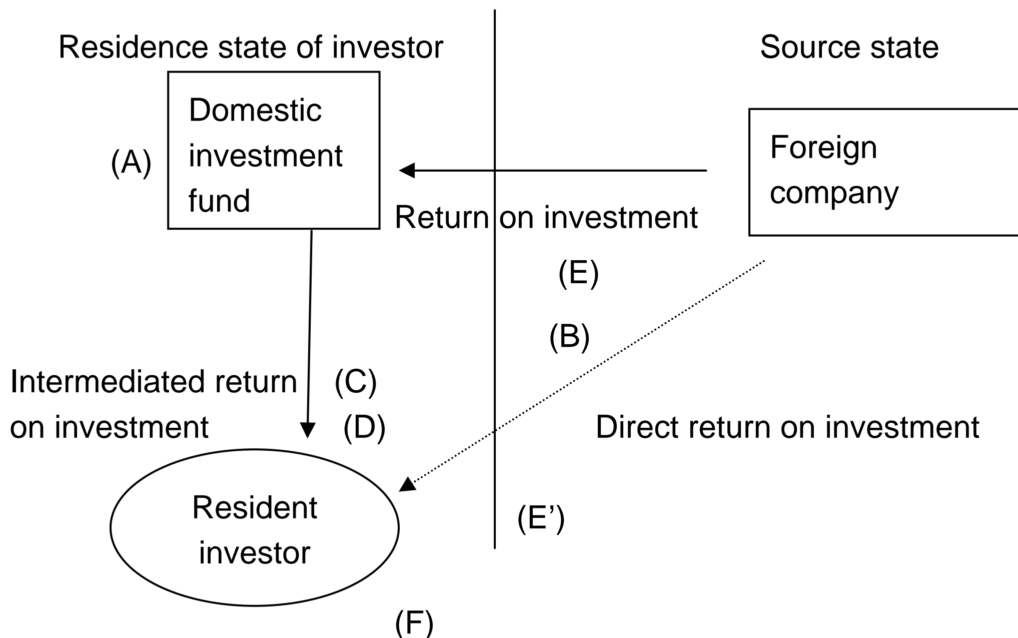

Figure 6. Tax Neutrality Considerations in the Cross-Border Context: Direct Investment vs. Investment through a Domestic Fund.[1370]

While in the above cases the fund investment takes place through a domestic investment fund, the most complicated situation – from the perspective of tax neutrality – is the one where an investment is made by a resident investor through a foreign investment fund. In this respect, a distinction must be made between the ‘two-country case’, where the income is derived within the state in which the investment fund is resident, and the ‘three-country case’ (hereinafter ‘triangular case’), where the income is derived from another state than that in which the fund resides. Generally speaking, investment funds do not usually limit their investments to domestic securities, so that the triangular case generally better reflects the reality.[1371]

When neutrality between direct investments and fund investments is pursued, the set of considerations in the triangular case differs from the

[1370] Adapted from OECD (1999) 52.
[1371] See OECD (1977) 6.

situations described above. The differences derive mainly from the fact that the taxation of the investor and the investment fund take place in different jurisdictions. Hence, from the perspective of the investor's residence state, the way in which the taxation of the investor is to be coordinated with that of the (foreign) investment fund is also influenced by the tax treatment of the latter in its residence state. The main considerations arising when tax neutrality is pursued ('C'), and the means to achieve it ('M'), in the triangular case, are generally the following:

A) C: Elimination of double taxation of income
M: Taxation at the investment fund level cannot be determined by the investor's state of residence, but credit at the investor level is possible[1372]

B) C: Channelling of reliefs (imputation credit, exemptions etc.) attached to income.
M: Flow-through of income.

C) C: Prevention of deferral of income.
M: Deemed distribution or offshore funds legislation.

D) C: Application of the same tax rates.
M: Flow-through of income.

E) C: Withholding tax rates at source on income when paid to the foreign investment fund (E) and the direct investor (E') respectively.
M: Tax rates are dependent on the applicable tax treaties and entitlement to treaty benefits.

F) C: Foreign withholding taxes paid by the investment fund.
M: A credit at the investment fund level cannot be effected by the investor's residence state, but a credit at the investor level is possible.[1373]

G) C: Foreign withholding taxes paid by the investor.
M: A credit at the investor level.

[1372] This is of concern only if an investment is made through an investment fund which is subject to tax on its earnings, as in the United Kingdom. As the residence state of the investment fund does not generally extend a credit for taxes paid by the investment fund to non-resident investors, the elimination of double taxation depends on the investor's state of residence.

[1373] Claiming a foreign tax credit in respect of withholding taxes imposed at source involves difficulties for investors who are not resident in the same state as the fund. In the first place, the measures aimed at matching foreign withholding taxes and taxes payable by the fund, or by underlying investors residing in the same state as the fund, are not extended to non-resident investors.

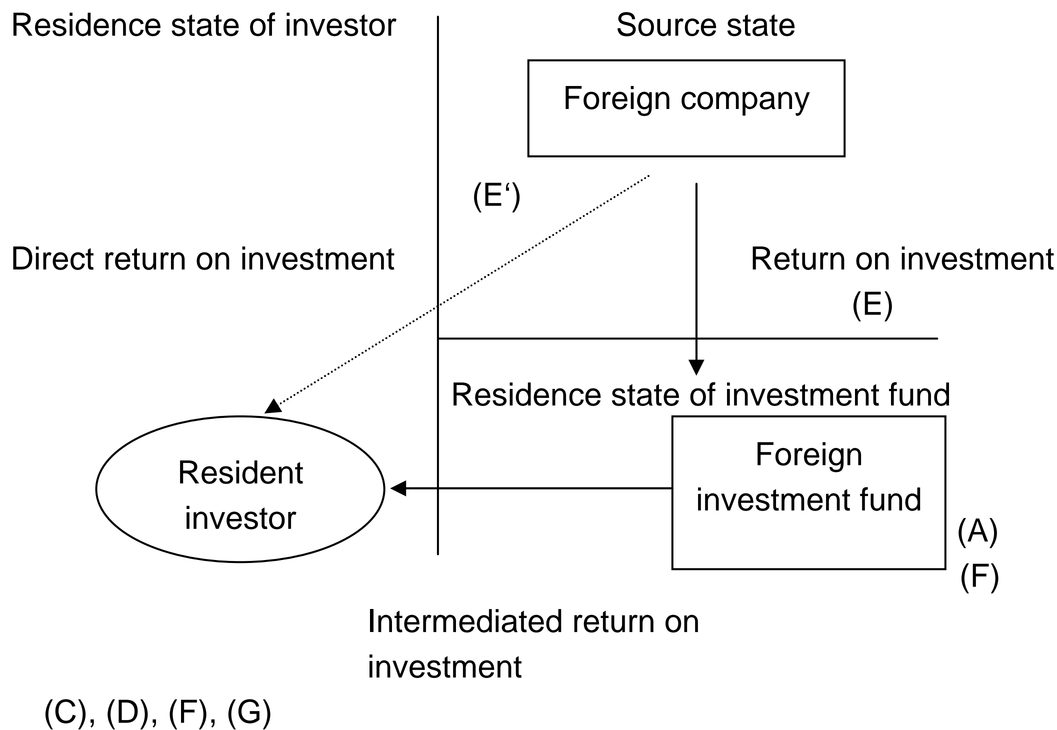

Figure 7. Tax Neutrality Considerations in the Cross-Border Context: Direct Investment vs. Investment through a Foreign Fund.[1374]

8.2.1.3 Single Market Neutrality

Member States are bound by a neutrality requirement which follows directly from the rationale of the single market (‘single market neutrality’).[1375] In the single market, investment funds from different Member States should be able to compete on a level playing field for prospective investors: whether they are resident in the same Member State as the investor or in another should be of no significance. In view of the tax treatment of fund investors therefore, the requirement posed by the single market neutrality is that the taxation should not affect the choice as to whether they place money in an investment fund established in the same Member State or in another. From a tax policy point of view, this would call for CEN, in that post-tax rates of return should not influence the investor’s choice between a domestic and a foreign investment fund made on the basis of pre-tax rates of return.

It is important to note that neutrality as required by the single market, on the one hand, and neutrality between a direct and an intermediated investment,

Neither is it usually possible for the non-resident investor to obtain a tax credit in the resident state in respect of withholding taxes suffered by the fund.

[1374] Adapted from OECD (1999) 58.

[1375] See Vogel (1994) 7; Ståhl (1997b) 231.

on the other hand, are different issues. Neutrality in the sense of the single market is neutrality between Member States.[1376] Neutrality between a direct and an intermediated investment addresses a separate issue. It may be more or less significant in determining whether investors prefer a direct investment over an intermediated investment, or vice versa. Therefore, in view of the success of the investment fund industry as a whole in a given Member State, this type of neutrality may be of importance. From the Community perspective, too, a neutral tax treatment between direct investments and fund investments may be of importance, in view of the overall size and competitiviness of the investment fund industry in the Member States as a whole, as compared, for example, to the United States. Moreover, from the perspective of a single financial market as a whole, the neutrality between direct and intermediated investments may be of importance. However, neutrality of this type is clearly secondary to the objective of the Community to establish a single market for investment funds.

The single market neutrality is also legally binding for the Member States, since it is enshrined in the fundamental freedoms of the EC Treaty, which may ultimately be enforced through the rulings of the ECJ. As shown in Chapter 7, the existence of a variety of tax provisions applied by the Member States, aimed at providing neutrality between direct and fund investments, is not necessarily compatible with the EC Treaty, since they hamper transactions with a cross-border element. Consequently, they must either be totally abolished in favor of EC-compatibility and the single market neutrality, or alternatively they must be extended to cross-border transactions, in order to comply with Community law and therefore also to fulfill the single market neutrality.

8.2.2 Tax Enforcement

The single market, with free movement of capital across the borders of the Member States, not only promotes economic efficiency but also creates opportunities for tax avoidance and evasion.[1377] Generally speaking, national tax authorities find it more difficult to levy taxes on cross-border activities undertaken by resident taxpayers in other Member States.[1378] The consequence of ineffective tax enforcement may well be a non-taxation situation, whereby the income is subject to tax neither in the source state nor in the residence state.

[1376] See Vogel (1994) 21.
[1377] Terra – Wattel (2001) 461.
[1378] See Ruding Report (1992) 41.

This in turn results in distortions in tax neutrality in the single market, in unfair taxation and in budgetary losses for the Member States.[1379] The necessity of measures assisting national tax authorities in combatting tax evasion in the wake of an increasing cross-border activity in the single market is also expressly recognised by the Commission as one of the priorities in tax policy.[1380]

As discussed in Chapter 6, in the case of non-voluntary compliance, an investment by a resident investor in a foreign investment fund raises difficulties in tax enforcement by national tax authorities. From the perspective of national tax authorities, the main drawback to the enforcement of taxation in the case of a cross-border fund investment relates to the lack of information exchange between tax authorities. Hence, while in the case of a domestic fund investment, there generally are possibilities for tax authorities to receive tax relevant information – not only from the taxpayer himself, but also from the investment fund or the paying agent – in a cross-border fund investment the tax authorities must often rely merely on the declaration of the taxpayer. The adoption of the Savings Tax Directive will change this situation to the extent that there is interest income involved, but this will not be enough to resolve all tax enforcement problems related to investment fund investments.

An ineffective taxation of income from cross-border fund investments distorts tax neutrality (CEN) between domestic and cross-border investment fund investments. To make the matter worse, the non-taxation of income in the residence state of the investor is often accompanied by the non-taxation of the income in the fund's residence state. This may be the case either because the income is realized in the form of a capital gain which is not taxable in the source state, or because the source state does not levy tax on a distribution paid by an investment fund to a non-resident investor. Should a distribution be subject to tax in the source state, the distortive effect of non-taxation in the investor's residence state would be weaker, and would be limited to the difference in the applicable tax rates between the investor's residence state and the investment fund's residence state. However, in the majority of cases, non-resident investors are likely to avail themselves of the possibility of accumulating income in the fund and eventually to realize the income as capital gains by way of redeeming the units, thereby avoiding any withholding tax.

[1379] See Terra – Wattel (2001) 461-462.
[1380] See COM (2001) 260 final, p. 24.

8.2.3 Other Objectives

Practical feasibility. When taxing income derived from investment funds, tax legislators and tax authorities are frequently also confronted with technical problems. The complexity of investment fund structures, combined with the objective of tax neutrality between direct and intermediated investments, is liable to lead to very complicated tax regimes. Such tax regimes are not only difficult to administer but also usually increase administration costs[1381] on the side of tax authorities and compliance costs on the side of taxpayers[1382]. Similarly to tax enforcement problems, practical difficulties generally are greater in cross-border transactions.[1383]

The practical feasibility of tax provisions often conflicts with the objective of reaching tax neutrality between direct and fund investments.[1384] While tax neutrality calls for complicated tax regimes, simplified tax regimes often run the risk of not being neutral in their treatment as between direct and fund investments. On the other hand, tax provisions which only nominally provide tax neutrality – because they are too difficult either to comply by taxpayers or to enforce by tax authorities – should be avoided. Examples of such provisions include (often cumbersome) tax treaty provisions providing for a refund of withholding taxes by reference to resident underlying investors of investment funds.

Taxpayer equity. Generally, equity among taxpayers is regarded as a fundamental feature of a good tax system.[1385] For the purposes of this study, it is safe to assume that taxpayer equity would be satisfied whenever two resident investors are treated in the same way in the residence state, irrespective of whether they have made a direct investment or an intermediated investment, whether through a domestic or foreign investment fund, in the same underlying securities.[1386]

Internation equity. Internation equity requires that distribution of tax revenues between different states be relatively fair.[1387] Internation equity rests on two widely accepted principles adopted in the OECD Model Convention.

[1381] For administration costs, see Musgrave – Musgrave (1989) 278-279.
[1382] For compliance costs, see Musgrave – Musgrave (1989) 279. According to them, compliance cost may be much higher than administration cost.
[1383] See Azzi (1993) 554.
[1384] For the case of Germany, see *Investmentmodernierungsgesetz/Entwurf,* 295.
[1385] See Musgrave (1987) 207. For more detailed taxpayer equity considerations in the context of portfolio investments, see Ståhl (1996) 121-124.
[1386] Generally, the responsibility for ensuring that the taxation is equitable can be assigned to the residence state of the investor. See Vapaavuori (1991) 54. See also Ruding Report (1992) 38-39, which essentially seems to equate the realisation of CEN with taxpayer equity. See also Gunnarsson (1998) 458, stating that the difference between neutrality and equity is not always clear.
[1387] Azzi (1993) 548.

First, under the principle of source-state entitlement, the source state of income has the prior claim to tax income arising within its jurisdiction.[1388] Second, in line with the principle of reciprocity, the rates of withholding taxes at source are the same between the contracting states.[1389] It seems that the taxation of fund investors does not raise any particular issues related to internation equity, since they are generally treated similarly to other non-resident portfolio investors. As for investment funds, most Member States have exempted resident investment funds from taxes, whereas other service providers – such as management companies and depositaries – are, as a rule, taxed normally on fees paid by investment funds. On the other hand, non-resident investment funds are often treated differently, depending on the source state in question. Due to the differing views regarding the investment fund's entitlement to tax treaty benefits, the principle of reciprocity may, in practice, not be realized.

8.3 Solutions to Tax Problems in the Single Investment Funds Market

8.3.1 General Remarks

In the previous chapter of this study, it was concluded that negative integration will lead, to the extent it has not already been accomplished, to the abolition of restrictive national tax measures applied in the Member States. On the other hand, negative integration also has its obvious limits, and therefore cannot resolve all the problems which – as they have been identified in relation to investment fund investments – stand in the way of a functioning single market. In the first place, negative integration fails to resolve the problem of economic double taxation of income in connection with investment fund investments, though most probably only to the extent that investment funds receive income subject to withholding tax outside the Community. Secondly, negative integration cannot resolve the problem of an inefficient tax enforcement of cross-border fund investments by Member States' tax authorities. Conversely, it is arguable that negative integration may even make it more difficult for national legislators to enact anti-avoidance legislation, with a view to ensuring enforcement of tax laws. This follows from the strict approach of the ECJ to the compatibility of anti-avoidance legislations with Community law.

[1388] See Vogel (1988) 398.
[1389] See Ruding Report (1992) 37-28. For a more detailed discussion, see also Musgrave (1987) 202-207.

There are generally two different approaches to dealing with the existing tax obstacles and problems with a view to achieving a functioning single market.[1390] The first would be to address the existing tax obstacles and problems one by one, and to search for a specific solution for each obstacle or problem. The second approach would consist of finding more comprehensive solutions which would address the identified obstacles and problems at once in a more unified manner. Broadly speaking, the latter approach should entail a full or partial harmonization of different tax systems applied by Member States. On the other hand, the former seems to allow the existence of different national systems across Member States, though with some coordinating measures to be taken at the Community level to the extent this is deemed necessary.

Unlike in some other fields of taxation, particularly in company taxation, the Commission has not set out any comprehensive approach to the taxation of investment funds and their investors within the European Union. It is also notable that the Commission has departed from its earlier position, of aiming for a broad harmonization of Member States' tax systems, in favor of divergent tax systems with coordinating measures to ensure the compatibility of the systems with the single market.[1391] In this regard, in the recently-issued communication by the Commission dealing with the elimination of tax obstacles to the cross-border provision of occupational pensions, the chosen approach was clearly based on the finding of specific measures instead of comprehensive solutions. In line with the approach of the Commission, the examination in this chapter also is based on the search for *specific* measures to cope with some of the remaining tax issues in the single investment funds market.

The following sections of this chapter discuss specific measures related to tax treatment and tax enforcement, with a view to achieving a functioning single market for investment funds within the European Union. The main objective of the proposed measures is to provide a neutral tax treatment as between investments made through domestic and foreign investment funds in the sense of the single market neutrality. Moreover, any measures discussed are also, as appropriate, examined in light of the following tax policy considerations:

1. Measures should take into account prevailing differences in the tax regimes governing taxation of investment funds and their investors within the European Union, thereby not requiring a broad harmonization of such regimes ('coexistence of different systems');

[1390] See COM(2001) 582 final, p. 306.
[1391] See COM (2001) 260 final, p. 9.

2. Measures should, to the extent possible, also contribute to neutrality between direct investments and investment fund investments;
3. Attention should also be paid to practical feasibility of the measures;
4. Attention should also be paid to a fair allocation of taxing rights between Member States.

The means by which the proposed measures could, in practice, be adopted are considered only very briefly. As regards measures related to the tax treatment of investment funds and investors, only the question will be discussed as to whether multilateral measures through secondary Community legislation are necessary, or whether, from the perspective of the single market, bilateral measures through tax treaties, or even unilateral measures by Member States, would suffice in line with the principle of subsidiarity. In terms of secondary Community law, the issues of the legal basis and the form of measures will be left open. This is because the emphasis in the chapter is placed on the finding of substantive measures to resolve the identified tax problems. For this reason also, no analysis will be made of the procedural merits and disadvantages of achieving positive integration by way, on the one hand, of secondary legislation, and, on the other, of bilateral or multilateral instruments.

As regards the measures related to tax enforcement, the discussion is, with good reason, based exclusively on the models adopted in the Savings Tax Directive. On the one hand, the impact of the Savings Tax Directive on the single investment fund market will be examined. On the other hand, it will be considered whether it is possible that solutions may be found – in line with the measures introduced in the Directive – which cover not only interest income but also other types of income received based on cross-border fund investments.

8.3.2 Measures Related to Tax Treatment

8.3.2.1 Abolition of Withholding Taxes in the Source State of Income

In Chapter 5, it was found that withholding taxes levied on income paid to investment funds in the source state of income are a common source of non-neutrality between investments in domestic and foreign investment funds. First and foremost, this is the case when an investment in domestic shares through a domestic investment fund is compared to that made through a foreign investment fund. The reason for non-neutrality is that only domestic investment funds are exempted from taxes in respect of their income. By

contrast, foreign investment funds are subject to withholding tax in the Member State where the income is derived, such tax frequently not being creditable for the investment fund or the investor. Secondly, withholding taxes also contribute indirectly to non-neutrality between domestic and cross-border fund investments, to the extent that such taxes can be credited only in the case of domestic fund investments (cf. France). Finally, withholding taxes are also the main cause of the non-neutrality between a direct cross-border investment and a cross-border investment through an investment fund. Fund investors will often end up in a disadvantageous tax position, as compared to direct investors, on account of uncreditable foreign withholding taxes.

Obviously, the problem of uncreditable taxes could be solved by abolishing withholding taxes on the income paid to non-resident investment funds.[1392] In the previous chapter of the study, it was also shown that a levy of withholding taxes on income by a Member State, in the case of non-resident investment funds established in other Member States, is likely to be incompatible with Community law, provided that resident investment funds are exempted from taxes. In particular, such withholding taxes restrict the free movement of capital by inducing investments by investment funds in their residence state. From the perspective of the single market, tax-driven capital movements and disintegration of capital markets within the Community are increased.

A positive solution – to abolish withholding taxes at source as far as non-resident investment funds are concerned – may, in principle, be sought unilaterally, bilaterally through tax treaties, or multilaterally at the Community level.[1393] From the single market perspective, it is obvious that the solution should preferably consist of multilateral measures taken up at the level of the Community. Measures taken by only some Member States unilaterally, or agreed bilaterally between some Member States, would only partly resolve the neutrality problem. For example, while an abolition of withholding tax on a dividend by Member State A would, from the perspective of an investment fund resident in Member State B, enhance neutrality between an investment in domestic shares in Member State B and foreign shares in Member State A; it would at the same time increase non-neutrality between investments in shares in Member State A or B, respectively, and another Member State C. Nonetheless, in relationships between the Member States and third countries, a bilateral solution could be considered as an appropriate means to eliminate the problem.

[1392] An alternative approach, of providing for a full credit of withholding taxes either at the fund level or investor level, will be examined in the subsequent section.

[1393] In principle, a multilateral solution is also possible at the level of the Member States, though this does not seem very likely.

Before proposing any measures to abolish withholding taxes at source, it is appropriate to address the two important functions of the withholding tax. In the first place, the withholding tax has an impact on the distribution of tax revenues between the source state of income and the residence state of the investor.[1394] Therefore, this is essentially an issue of internation equity, in the sense that it contributes to a fair division of tax revenues between the Member States. It is a widely-accepted principle, in the field of international tax law, that the source state is entitled to tax income originating within its borders, even if the recipient of income is non-resident.[1395] Secondly, the withholding tax plays an important role in enforcement of taxation, and collection of income, thereby preventing tax avoidance and evasion by taxpayers. The imposition of withholding tax in the source state of income effectively ensures that the income received by a non-resident investor is subject to taxation at least by the amount of withholding tax, irrespective of whether the investor declares such income to the tax authorities of the residence state.

Keeping the above-mentioned functions of the withholding tax in mind, it must be considered whether a multilateral solution – to abolish withholding taxes in respect of income paid to investment funds – could be reached in the Community. Here a parallel can be made to the agreement reached in the form of the Parent-Subsidiary Directive in 1990. The Parent-Subsidiary Directive abolished withholding taxes in the source state of income, as far as direct investment dividends of affiliated companies are concerned. Even though the Parent-Subsidiary Directive does not cover portfolio dividends, its adoption demonstrates that it is not unreasonable to expect the Member States to be willing, under certain conditions, to give up their taxing right in their capacity as the source state of dividend income.

Several conditions agreed in the Parent-Subsidiary Directive are such that they effectively exclude investment funds from its scope.[1396] This is because, in order to qualify for the benefits of the Parent-Subsidiary Directive, the recipient of a dividend should be an entity which takes one of the legal forms listed in the annex to the Directive.[1397] In addition, the recipient entity is required to be subject to corporate tax without the possibility of being exempt.[1398] Finally, there is also the requirement for a holding of at least 20 per cent (prior to the amendment 25 per cent) of the capital, or voting rights, of the distributing company.[1399] This cannot be the case for investment funds

[1394] See Vanistendael (1997) 152
[1395] See Musgrave (1987) 198; OECD (1991) 36.
[1396] See, for example, Schwarz (1991) 54.
[1397] Art. 2(a) of the Parent-Subsidiary Directive.
[1398] Art. 2(c) of the Parent-Subsidiary Directive.
[1399] Art. 3(1)(a) and 3(2) of the Parent-Subsidiary Directive.

qualifying as UCITS because of the investment policy restrictions laid down in the UCITS Directive.[1400]

The exclusion of investment funds continues generally to be the case, despite the recent amendments to the Parent-Subsidiary Directive[1401]. The minimum holding threshold will decrease gradually from 20 per cent to 15 per cent from 1 January 2007 and to 10 per cent from 1 January 2009. Furthermore, the type of companies to which the Directive applies was extended. Even though the UCITS Directive allows an investment fund to hold a 10 per cent share of a company, and even though at least one Member State has included an investment fund in the annex of the amending directive enumerating the types of qualifying companies[1402], it is not clear that the investment fund could benefit from the Directive, insofar as it is exempted from taxes in the Member State.[1403]

Even if not generally applicable to investment funds, the Parent-Subsidiary Directive may help to understand the conditions under which it is reasonable to expect Member States to be willing to waive their taxing right as a source state of income. In the first place, the waiving of taxing right is based on reciprocity, so that each of the Member State must refrain from imposing withholding tax on the qualifying income in the capacity of a source state. In the second place, the Directive similarly requires a Member State, in its capacity as a residence state of the parent company, either to exclude the distribution from taxation, or alternatively to include the distribution in the tax base of the parent company, with an indirect credit given for taxes incurred in the source state at the level of the subsidiary company. Nonetheless, the Parent-Subsidiary Directive does not prevent the residence state of the parent company from levying tax on the same income when redistributed by the parent company, unless the redistribution also falls within the scope of the Directive.[1404]

[1400] In addition, there is the requirement, the adoption of which is up to each Member State, that the shareholding lasts at least for an uninterrupted period of two years (Art. 3(2)). Even though this requirement can be met by an investment fund with a passive investment policy, it is arguable that the majority of investment funds change the composition of their portfolio more actively, which makes the meeting of the condition exceptional.

[1401] Council Directive 2003/123/EC of 22 December 2003 amending Directive 90/435/EEC on the common system of taxation in the case of parent companies and subsidiaries of different Member States, OJ L 7, 13/01/2004 p. 41-44. See also COM (2003) 463 final.

[1402] The Netherlands has included in the list of qualifying companies the '*Fonds voor gemene rekening*', which is a non-corporate form investment fund qualifying as UCITS. However, the profits of such an investment fund qualify, subject to certain conditions, for 0 per cent corporate tax. See de Jong – Vink, Investment Funds, 84-93. See also Thömmes – Nijs (2003) 558, who mention 'funds' as one type of company to which the Parent-Subsidiary Directive would be extended under the proposed amendments.

[1403] See Brokelind (2003) 453.

[1404] See Ståhl – Österman (2000) 217.

As for investment funds, the starting point is somewhat different from that of ordinary companies. Unlike the latter, investment funds are not generally taxed in their Member State, so that some Member States might be reluctant to waive their taxing right in the capacity of a source state for nothing. Nonetheless, even in the Parent-Subsidiary Directive, the residence state must exempt the qualifying income from taxation. In addition, as in the case of ordinary companies, the residence state of the investment fund could still levy withholding tax on distributions, when paid out by a resident investment fund to non-resident investors. Of course, the Member State can also eventually tax such income in the hands of underlying investors to the entent that these are residents. Moreover, in the absence of withholding taxes at source, there would be no need to grant a relief for withholding taxes suffered by an investment fund against income taxes to be paid by the investor. This, of course, comforts only those Member States (such as Germany and France) which currently allow a relief at the investor level for withholding taxes suffered by the investment fund, or the United Kingdom which allows relief at the fund level.

Returning to the important functions of the withholding tax, it has been argued that elimination of withholding taxes at source does not generally conflict with the principle of source-state entitlement. This is because the source state of income, in its quality as a residence state of the company, is already entitled to tax the profits of the company.[1405] In fact, the entitlement to tax the profits of distributing companies is also the underlying reason for the limitation of source-state tax rates in the OECD Model Convention.[1406] As for investment funds, their importance as suppliers of capital (equity or debt), out of which the profits are produced by resident companies, is widely appreciated. Since the profits of resident companies are in any case taxable in the source state of income, it might not be unreasonable to exempt the income paid to investment funds from withholding taxes, on account of benefits brought by investment funds. It is arguable that the elimination of distorting withholding taxes in respect of non-resident investment funds would indirectly benefit the source state owing to a more effective supply of capital.

The second issue arising, when considering abolition of withholding taxes at source, relates to tax evasion. The role of withholding tax as a means of effective tax enforcement cannot be disregarded.[1407] Generally speaking, the importance of withholding tax in terms of tax control is greater with respect to individual investors than to corporate investors. While corporate investors are

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[1405] See Ståhl (1996) 396; Easson (1997) 113.
[1406] See Art. 10 para. 9 and 11 para. 7 of the OECD Model Commentary.
[1407] See Ståhl (1996) 396; Vapaavuori (1991) 218-219.

subject to accounting requirements in their residence state – the tax authorities thereby being able to verify the declared income – this is not the case for individual investors. Rather, taxation of foreign-source income by an individual investor in the residence state generally depends on whether the investor spontaneously declares such income to the tax authorities. Should the investor not report his foreign-source income, effective taxation of such income will be determined solely by the amount of withholding taxes suffered in the source state of income.

For the sake of clarity, it must be mentioned that tax evasion concerns do not of course directly relate to investment funds as recipients of income. Firstly, investment funds – as other institutional investors generally – are strictly regulated, with the obligation to keep accounts of income they receive. Secondly, investment funds generally are tax-exempt, so that the problem of tax evasion at the fund level does not in any case exist.

Therefore, the real concern of both the source state and the residence state tax authorities must be to ensure that the income paid to the investment fund is eventually taxed in the hands of underlying investors. In this respect, it is essential to distinguish between investors resident in the same state as the investment fund and non-resident investors. Since investment funds are strictly-regulated financial intermediaries, reporting duties are often imposed on them, towards national authorities including tax authorities in their residence state. As a result, information required for taxation purposes concerning income (be it in the form of distributions or capital gains) is effectively communicated to tax authorities, as far as investors resident in the same state as the investment fund are concerned.

However, this generally is not the case for non-resident investors of the investment fund. As shown previously in Chapter 6 of this study, lack of effective information exchange between national tax authorities of Member States leads to a considerable risk of tax evasion by investors participating in foreign investment funds. The elimination of remaining withholding taxes at source, on income received by investment funds, would therefore increase the already existing risk of non-taxation of income received through foreign investment funds. This in turn is liable to have an adverse impact on the neutrality as between cross-border investments made through foreign investment funds and those made through domestic funds or directly by investors. In view of this, the abolition of withholding taxes at source when paid to non-resident investment funds should be combined with measures that ensure effective taxation of income in the hands of non-resident investors of investment funds within the European Union.[1408]

[1408] Measures related to tax enforcement will be examined in Chapter 8.3.3 of this study.

A multilateral solution at the level of the Community would leave untouched the problem of uncreditable withholding taxes suffered by investment funds in countries outside the European Union ('third countries'). With respect to withholding taxes suffered in third countries, a bilateral solution could be sought by the residence state of the investment fund and the relevant source state of income through bilateral tax treaty negotiations. Such a solution could consist of an agreement to treat investment funds as a resident of a contracting state for tax treaty purposes, and therefore to allow their access to the lower withholding tax rates generally provided by tax treaties. However, by this method the problem of uncreditable third-country withholding taxes would generally be only alleviated rather than totally abolished, as most tax treaties do not provide total exemption from withholding taxes at source. In this respect, the new United Kingdom-United States tax treaty[1409] serves as an interesting example, in that dividends paid to certain UK pension schemes are fully exempt from withholding tax at source in the United States.[1410] Although this exemption does not apply to investment funds generally[1411], it shows that it is not entirely unrealistic to expect even third countries to be willing to give up their taxing right, as the source state of income, on dividends paid to non-resident investors residing within the European Union.[1412] It must also be mentioned that the exemption of pension schemes provided for by the United Kingdom-United States tax treaty is subject to the limitation-on-benefits article.

In conclusion, it is submitted that the Member States should seek a multilateral agreement at the Community level to abolish withholding taxes on dividends in the source state of income, when paid to investment funds (UCITS) established in other Member States. Optimally, such an agreement would cover even dividends paid to portfolio investors investing directly without an intermediary, in order to facilitate neutrality between intermediated and direct cross-border investments. Nonetheless, on account of the fact that portfolio investors are in any case entitled to a credit for the remaining withholding taxes in the residence state, the extension of an agreement to that

[1409] The treaty was signed on 24 July 2001 with an Amending Protocol signed 19 July 2002 and entered into force on 31 March 2003.

[1410] Art. 10(3)(b) of the United Kingdom-United States tax treaty. The exemption does not apply when a dividend is derived from the carrying on of a business by a pension scheme. See Connors – White (2003) 215; Avery Jones (2001a) 557. Naturally, the exemption under the tax treaty is relevant only for UK resident pension schemes receiving US-source dividends, because the United Kingdom does not levy a withholding tax on dividend under its domestic tax law.

[1411] This follows from the definition of a pension scheme in Art. 3(1)(o) of the treaty which defines it as "any plan, scheme, fund, trust or other arrangement […] operated principally to administer or provide pension or retirement benefits or to earn income for the benefit of one or more such arrangements". The qualifying pension schemes are listed in the Exchange of Notes to the Treaty.

[1412] See also Oliver (2003), who states: "[…] the US may be prepared to cede to other countries the benefit of a nil dividend withholding tax rate where a treaty can be re-negotiated on acceptable terms."

category of investors is not a necessity from the perspective of tax neutrality. In fact, this would correspond to the outcome which is likely eventually to be produced by negative integration. Finally, any agreement to abolish withholding taxes should be combined with additional measures to ensure an effective taxation of income.

8.3.2.2 Elimination of Double Taxation of Income

Whereas the previous section concerned itself with the abolition of withholding taxes – which may be described as the cause of non-neutrality – this section will consider whether the symptoms, that is non-neutrality caused by uncreditable foreign withholding taxes, can be tackled by way of measures taken at the Community level. While in some Member States, such as Germany and France, there are unilateral measures providing for credit of foreign withholding taxes suffered by an investment fund, such mechanisms have traditionally been confined to resident investors of domestic investment funds. As shown in Chapter 7 of this study, tax credit mechanisms confined to investors of domestic funds are, from the Community law perspective, dubitable, because they are liable to discourage resident investors from using investment funds established in other Member States as a means of a cross-border investment.

In the face of this, incompatible tax credit mechanisms may either be totally abolished, or replaced by measures which are compatible with Community law, as Germany recently has done. As for the first alternative, the total abandonment of foreign tax credit mechanisms cannot be regarded as the most satisfactory solution. After all, there is a legitimate tax policy concern that the abolition of foreign tax credit mechanisms will put fund investors in a disadvantageous position as compared to direct investors, as far as cross-border investments are concerned.[1413]

At the Community level, the importance of eliminating double taxation has also been recognised. In connection with an early proposal of 1978 by the Commission to harmonize company taxation systems and withholding taxes on dividends, measures were planned to eliminate double taxation in respect of dividends received through investment funds.[1414] More recently, the proposal of 1998 for the Savings Tax Directive stated that it was "advisable to provide suitable measures to ensure the elimination of all double taxation borne by the

[1413] Though the disadvantage caused by uncreditable taxes may be compensated by other tax advantages.

[1414] COM(78) 340 final.

interest” in the context of investment fund investments.[1415] Consequently, the 1998 proposal also contained provisions on elimination of double taxation of interest income received through investment funds by individual investors. However, the Savings Tax Directive in its adopted form finally failed to deal with the issue.

In addition to the efforts made in the Community, the issue of double taxation of income in connection with investment fund investments has been subject to study at the level of multinational organisations for several decades. However, some of these studies (IFA 1971 Report[1416], IFA 1997 Report[1417]) focused only on how to relieve, by means of tax treaties, withholding taxes on income paid to the investment fund in the source state of income, rather than considering the availability of foreign tax credits at the investor level. The OECD 1999 Study[1418] did consider the issue of foreign tax credits, but failed eventually to propose any mechanism to deal with the triangular case, which is the trickiest case from the perspective of the single market. In fact, only the OECD 1977 Study[1419] went on to propose arrangements which intend to eliminate double taxation, and irrespective of whether or not underlying investors of the investment fund are resident in the same state as the fund.

Before examining the details of the measures, it is proper to summarise the available theoretical methods of avoiding the double taxation resulting from foreign withholding taxes in the context of investment funds. Generally, there are three options to eliminate double taxation either at the fund level or investor level[1420]:

1. Credit at the fund level against corporate tax;
2. Credit at the fund level against withholding tax;
3. Credit at the investor level against income tax.

In the following, the conditions under which each method is generally feasible are first discussed. This will be followed by consideration of whether any of the methods proves to be an appropriate method of eliminating double taxation of income from investment fund investments within the European Union.

Corporate tax method. Apparently, the most straightforward method of eliminating double taxation would be to grant the investment fund a credit for foreign withholding taxes against its own corporate tax liability. This would correspond to the treatment of ordinary companies. The prerequisites for the

[1415] Recital (21) in the preamble of the 1998 proposal for the Savings Tax Directive (COM(1998) 295 final).
[1416] See IFA (1971).
[1417] See IFA (1997).
[1418] See OECD (1999).
[1419] See OECD (1977).
[1420] See OECD (1999) 64.

method to be feasible are actual corporate tax liability at the fund level, as well as an imputation credit at the investor level for corporate taxes paid by the fund. However, owing to the fact that, in most Member States investment funds are not effectively subject to corporate tax, this method seems not to be an appropriate candidate. Moreover, it fails to resolve the double taxation of income to the extent that there are non-resident investors in the fund, because the corporate tax paid by the investment fund itself would generally not be creditable in the residence state of a non-resident investor.[1421]

Withholding tax method. The second elimination method would be based on a credit for foreign withholding taxes given against the withholding tax on distributions paid by the investment fund. The outcome of this method is, ideally, that the income received by an investor be subject to withholding tax at the same rate in the source state of income, irrespective of whether it is received directly or through an investment fund, with the remaining withholding taxes being creditable in the investor's residence state. The following simplified example will clarify the operation of the withholding tax method:

	Fund investment	Direct investment
Source state tax (treaty rate)	15	15
(Fund state tax (domestic rate)	25)	-
(Fund state tax (treaty rate)	15)	-
(Fund state credit for source state tax	15)	-
Fund state tax (effective)	0	-
Investor state credit (treaty rate)	15	15

The withholding tax method was subject to an extensive examination in the OECD 1977 Study. At the Community level, the withholding tax method was also one of the two alternative methods for alleviating double taxation of income received through investment funds, put forward in the 1978 proposal concerning harmonization of company and withholding taxes on dividend and in the 1998 proposal for the Savings Tax Directive.[1422]

[1421] For investors resident in the same state as the fund, a credit for corporate tax paid by the fund would generally be granted under national tax rules (cf. the United Kingdom). However, for non-resident investors, additional measures should be adopted to facilitate either an indirect credit for corporate taxes paid by the fund in the residence state of the non-resident investor, or a cash transfer of a credit to non-resident investors by the residence state of the investment fund.
Yet another possibility would be to follow the Dutch model, whereby a resident investment fund can obtain a reimbursement from the Dutch tax authorities for foreign withholding taxes. For the Dutch model, see de Jong – Vink (2003) 93. However, it leaves open the question as to how to treat resident investors in foreign investment funds.

[1422] See COM (78) 340 final and COM (98) 295 final.

For the purposes of examining the conditions under which the withholding tax method would be viable, it is useful to distinguish between the following stages of taxation in the course of an investment fund investment:

1. Taxation of the investment fund in the source state of income;
2. Taxation of the investment fund in the residence state;
3. Taxation of the investor in the fund's residence state;
4. Taxation of the investor in the residence state.

As for the taxation of the investment fund in the source state of income (stage 1), it is necessary that the fund itself be entitled to tax treaty benefits in the same way as would be the direct investor.[1423] This way will ensure that the fund will not be subject to taxes at source in excess of normal tax treaty rates. Otherwise, there would remain a risk of residual taxes after exhausting the tax credit measures provided for in the course of the withholding tax method.[1424]

As for the taxation in the residence state (stage 2), the fund should not be subject to effective taxation on its income.[1425] Otherwise, there would be another layer of taxes incurred at the fund level, such taxes not being creditable for non-resident investors. As noted earlier, this requirement often leads to a conflict with tax treaty access in the source state of income.

As for the taxation of the investor in the residence state of the investment fund (stage 3), withholding tax against which foreign withholding taxes can be credited should be imposed on any income paid out by the fund to its investors.[1426] The income paid out by the fund could be in the form of a distribution, as well as of proceeds on the redemption of fund units. The obligation to impose a withholding tax on income paid out by the fund is the core of the method in question, which in practice facilitates the neutralisation of taxes incurred by the fund in the source states of income. The rate of the withholding tax should be at least as high as the rate of the source state withholding tax, so as to be capable of neutralising the latter in whole. Assuming that the investment fund be entitled to tax treaty benefits in the source state, the tax rate at source generally would not exceed 15 per cent. Assuming that the residence state of the fund applies tax treaties to income distributed by the fund to its investors, and that it qualifies the distribution as dividend, the rate of tax on fund distributions would generally also be 15 per

[1423] See OECD (1977) para. 33. Note that the applicable tax treaty in the case of a fund investment and comparable direct investment respectively is naturally different from the perspective of a non-resident fund investor, because it is assumed that the investment fund is permitted independent access to the tax treaty between its residence state and the source state of income.

[1424] This results from the fact that withholding taxes levied in excess of tax treaty rates would often not be creditable in the residence state of the investor. On the other hand, in some cases withholding taxes levied at source could exceed the amount of taxes payable by the investor in his residence state.

[1425] See OECD (1977) para. 34.

[1426] See OECD (1977) para. 34.

cent.[1427] After allowing a credit for foreign withholding taxes (15 per cent) against the withholding tax on the distribution, in accordance with the treaty rate (15 per cent), the residence state of the investment fund would effectively forgo its right to tax fund distributions to the extent that the income is paid out to non-resident investors.[1428] In the case of a redemption of units, however, modifications to domestic and tax treaty provisions would be needed, since Member States do not at present apply withholding taxes on capital gains realized by non-resident investors, and tax treaties allocate the taxing right on such gains to the residence state of the investor.

Finally, as for the taxation in the investor's residence state (stage 4), a credit should be granted against the investor's tax liability, in respect of withholding tax imposed on the distribution or redemption proceeds paid out by the fund. Notably, the credit must correspond to the *fictitious* amount of withholding tax, which would have been leviable prior to crediting third-country withholding tax against the withholding tax in the residence state of the investment fund.[1429] Assuming that the distribution is, for tax treaty purposes, treated as dividend, and thus subject to 15 per cent tax at source in the fund's residence state, then the residence state should grant a tax credit of 15 per cent, even if the effective rate of withholding tax were nil, or at least lower than 15 per cent.[1430] Consequently, allowing a credit for the fictitious withholding tax is an absolute prerequisite for the withholding tax method to work effectively.[1431] Otherwise, the effect of crediting foreign withholding taxes in the fund state would be watered down from the investor perspective. This is because an uncreditable tax, i.e. third-country withholding tax, would simply be replaced with another one, i.e. withholding tax on the fund distribution.

As mentioned, the 1998 proposal for the Savings Tax Directive[1432] provided the withholding tax method as a way of eliminating double taxation of interest

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[1427] Most countries would, it seems, classify the distribution for tax treaty purposes as dividend. However, in some cases, it may also be classified as 'other income' or 'interest' in which case no withholding tax generally would be levied. To ensure proper functioning of the withholding tax system, a uniform classification of the distribution for tax treaty purposes would obviously needed.

[1428] As far as resident investors are concerned, the resident state of the investment fund would of course tax fund distributions under its domestic tax rules. The credit mechanism could be applied to resident investors in the same way as to non-resident investors. In the above example, the 15 per cent source state withholding tax would then be credited against the withholding tax of 25 per cent imposed on distributions under domestic law.

[1429] See OECD (1977) para. 34.

[1430] In principle, it does not make any difference whether the investor's residence state grants the tax credit under the tax treaty or domestic law. However, it is important that the investor's state also treats the fund distribution as dividend for tax purposes, and therefore recognises the fund state's right to impose withholding tax on the distribution. Should the investor's residence state qualify the distribution as 'other income' for tax treaty purposes, with the effect that the exclusive taxing right of such income belongs to the residence state, the tax credit would be in danger.

[1431] As far as investors are resident in the same state as the fund, the same would apply. In the above example, a credit of 25 per cent (fictitious rate) instead of 10 per cent (effective rate) should be given.

[1432] See COM(1998) 295 final.

income received through an investment fund by individual investors. The withholding tax method was nevertheless to be applied only by those Member States which had opted to withhold a tax on cross-border interest rather than exchanging information. Despite the fact that the Savings Tax Directive eventually failed to address the elimination of double taxation of interest in respect of third-country withholding taxes, it is appropriate to look into the elimination method as it was put forward under the 1998 proposal. Consideration will also be given as to whether it constitutes a proper solution to the problem of double taxation of income in the context of investment fund investments, in respect not only of interest income but also of other types of income.

The withholding tax method in the 1998 proposal was laid down in Article 10(3)(b):

> "[…] the paying agent shall reduce the withholding tax […] by the effective level of taxation incurred by the collective investment undertakings on the income corresponding to the interest paid to the beneficial owner. In that event the Member State of residence for tax purposes of the beneficial owner shall grant him a tax credit which covers the entire taxation effectively borne by the interest, up to the amount of tax due in its territory on such interest."

In accordance with the article, the paying agent was obliged to reduce the amount of withholding tax – set at 20 per cent – levied on interest paid out by the investment fund – whether in the form of a distribution or of proceeds from a redemption of units – by the effective level of taxation incurred by the investment fund on the same income. For the purposes of reduction, the paying agent had to be provided with the details concerning the attribution of creditable withholding taxes to the interest to be paid out by the fund. Obviously, this requirement would inevitably cause an additional administrative burden on both investment funds and paying agents. The reference to 'effective level of taxation' in practice meant that not only withholding taxes, but also any other types of tax potentially imposed on the fund, would have been creditable against the withholding tax on interest. In this way, investment funds subject to actual tax in their residence state were not discriminated against as compared to tax-exempted funds.[1433]

As far as the residence state of the investor was concerned, an ordinary credit corresponding to the entire taxation borne by the interest had to be granted to the investor. Consequently, the basis for the credit was not the effective withholding tax levied by the paying agent, but the fictitious one

[1433] In the case of taxes charged on the basis of net wealth, problems might occur in determining an appropriate tax burden on the interest to be paid out.

prior to crediting other taxes incurred by the fund. To the extent that the effective taxation incurred by the fund would exceed the withholding tax set by the Directive, the base for the credit would naturally be determined solely on the basis of the effective taxation. However, the maximum amount of the credit was limited to the amount of taxes due in the residence state of the investor.

Obviously, the withholding tax method as laid down in the 1998 proposal would provide a solution to the problem of double taxation of interest income in connection of fund investments. However, the problem of the method is that it requires a withholding tax to be levied on the income paid out by the fund. This is in contrast to the approach taken by the Community, which involves discarding the model based on the coexistence of withholding tax and information exchange systems in favor of the latter alone, the application of the withholding tax system being now limited to a transitional period.[1434] As a result, it seems that the withholding tax method cannot serve as a proper solution to the double taxation of income within the Community, at least as far as interest income received through investment funds is concerned.

Flow-through method. Finally, the method of crediting withholding taxes suffered by the fund at the investor level must be considered. The basis of this method is the recognition of the transparency principle, which results in the flow-through of the right to credit the imposed withholding taxes to the underlying investors of the fund.

The flow-through method was prescribed in the 1998 proposal for the Savings Tax Directive to the extent that a Member State of the paying agent had opted for the information exchange system as opposed to a levy of withholding tax. As the Savings Tax Directive no longer addresses the issue, no rules on the application of the flow-through are found. However, below the question will be considered as to whether the flow-through method of avoiding double taxation of income would serve as a proper solution within the Community.

The flow-through method as set out in the 1998 proposal was based on Article 10(3)(a):

> "[…] the member state of residence for tax purposes of the beneficial owner shall grant him, up to the amount of tax due on such interest in its territory, a tax credit equal to the effective level of taxation incurred by the collective investment undertakings on the income corresponding to the interest paid to the beneficial owner."

[1434] The exception granted to certain Member States, to apply the withholding tax system on interest, will however extend indefinitely in case the so-called third-country negotiations fail.

Owing to the absence of a withholding tax on interest paid out by the investment fund, the residence state of the investor, rather than that of the investment fund[1435], was obliged to eliminate double taxation of interest income. This was to be effected by way of granting an ordinary credit, for taxes paid by the fund, against the tax liability on the same income in the hands of the investor. As in the case of the withholding tax method, the article refers to 'the effective level of taxation' incurred by the fund. It follows that the article required the residence state of the investor to credit not only withholding taxes incurred by the fund in the source state of income, but also any other taxes incurred by the fund, particularly in its residence state. In practice, the article prescribed, where appropriate, an indirect tax credit to be granted to the investor in his state of residence, to balance the corporate taxes paid by the fund in its residence state.

The greatest disadvantage of the flow-through method is often considered to be the administrative burden on the part of tax authorities, and the compliance costs to taxpayers, caused by its application.[1436] To be sure, the burden of compliance should be placed primarily at the level of investment funds rather than of individual investors. For investment funds with enhanced accounting methods, the track-down of paid withholding taxes and their attribution to the relevant income paid out by the fund, would not generally constitute insurmountable difficulties. However, to a certain extent, the simplification of rules as regards the attribution of credit to underlying investors would probably be needed, in order to avoid a disproportionate burden at the fund level in the process of granting tax credits to investors. This would mean, for example, the application of an overall credit per distribution or proceeds rather than a per-item or per-country system.[1437] Obviously, there

[1435] To be specific, the state of the paying agent is decisive in case this is different from the state of the investment fund.
[1436] See OECD (1999) 65.
[1437] The differences between these two systems in the context of the flow-through method are highlighted in the following. When the per-item system is applied by the investor state, evidence should be provided, in regard to each separate item of income (ie. sorted by type of income), on the amount of income and withholding tax levied on the respective item of income. Consequently, in this case the distribution by the fund should be disaggregated by income type, and for each type of income the amount of imposed withholding taxes attributable to the respective distribution should be shown. When the per-country system is applied by the investor state, evidence should be provided in regard to income derived from different countries. Consequently, in this case the distribution by the fund should be disaggregated by source country, and for each country the amount of imposed withholding taxes attributable to the respective distribution should be shown. When the overall credit system is applied by the investor state, only a single tax credit for the whole distribution received by the investor must be calculated. Note also that generally it is impossible to achieve full transparency in the sense that the amount of withholding taxes incurred in the source state of income would be dependent on respective tax treaties between the source state and the residence state of underlying investors. Instead, the tax treaty between the fund's residence state and the source country would be applicable. See also OECD (1999) 71, note no. 12.

might arise numerous other technical difficulties, which could endanger the practical operation of the flow-through method if not properly resolved.

The flow-through method would not require substantive changes in the national tax regimes governing the taxation of investment funds. Should the fund be tax-exempted in its residence state, the residence state of the investor would grant a credit in respect of foreign withholding taxes suffered by the fund. Should the fund, however, be taxed in its residence state, the investor state would grant a credit for the taxes paid there by the fund.[1438] However, as regards the taxation of investors, Member States would need to enact measures which also facilitate the flow-through of tax credits in respect of resident investors in domestic investment funds, to provide for neutrality between domestic and cross-border fund investments.

From the perspective of internation equity, problems might arise if the residence state of the investor must eliminate double taxation not only in respect of foreign withholding taxes, but also of taxes levied on the income when paid out by the investment fund. It seems appropriate that if the residence state of the investor is obliged to eliminate double taxation in respect of foreign withholding taxes, the residence state of the investment fund ought not levy a withholding tax on distributions. Leaving the residence state of the investment fund without the right to levy tax on the income paid out by the fund to its non-resident investors, may not be considered as an inappropriate measure, if the obligation to eliminate double taxation is placed on the residence state of the investor. This is because the services of resident management companies to investment funds are generally taxed normally under corporate tax laws, the income of such companies consisting of management fees charged from the funds. Therefore, residence states of investment funds will not leave empty-handed, as was explained earlier. Moreover, the majority of income paid out by the funds constitutes capital gains realized at the redemption of units by investors, the income type which already is, as a rule, exempted from withholding tax in the case of non-resident investors.

Community solution or not? Apart from the issue concerning the appropriate method for eliminating double taxation of income, it must be considered whether the same method should be applicable to all types of income received through investment funds ('common solution'), or whether separate methods should be applied to different types of income ('partial solution'). The latter alternative would also allow for the possibility of eliminating double taxation in respect of only certain types of income (e.g.

[1438] Note that in this case the foreign withholding tax suffered by the fund is creditable against the fund's own tax liability in its residence state.

dividend). Generally speaking, the problem of double taxation is of more serious concern in respect of dividends than of interest or capital gains. While dividends received by investment funds are, as a rule, taxable in the source state of income both under domestic laws and tax treaties, interest and capital gains are often exempted from such taxes, either under domestic tax law or under tax treaties.

As the Savings Tax Directive in its current form has abandoned the coexistence-system in favor of information exchange as the sole system – apart from the transitional period – it seems that, in the long run, only the flow-through method is apt as far as interest income is concerned. It follows that, as far as a common solution – covering all types of income – to the elimination of double taxation is concerned, the Savings Tax Directive practically limits the available options to the flow-through method.

Under the partial solution approach, different methods of eliminating double taxation might be applied to interest and dividend income respectively. This would leave open a possibility for the application of the withholding tax method in dividends received through investment funds, irrespective of the solution, if any, agreed with respect to interest income. However, it is most unlikely that the partial solution would turn out to be such that different elimination methods were applied to different types of income, as this would cause great administrative and compliance burdens.

Finally, there is the option of *not* eliminating the double taxation of income, in the context of investment fund investments, through measures at the Community level. In fact, there are several arguments for that option. In the first place, benefits gained by fund investors from foreign tax credits may be disproportionate to the costs of introducing and maintaining the system. It is estimated that the combined effect of investment funds not benefiting from lower rates of withholding taxes under tax treaties, and of underlying investors not receiving foreign tax credits, amounts to 0,6 per cent of asset value in a typical equity fund.[1439] Even though the disadvantage may, in the long run, be considered relatively significant in comparison to management and depositary fees debited from investment funds, it is likely that the costs resulting from the increased burden of compliance on the part of investment funds would partially balance out the benefits to be gained by investors. Secondly, the tendency towards lower withholding tax rates at source, irrespective of measures taken at the Community level, is in itself liable to reduce the disadvantage caused by uncreditable withholding taxes, thereby decreasing the relative gains to be achieved through elimination measures. Thirdly, it is uncertain whether the Member States which allow deferral of tax by way of

[1439] FEFSI & PricewaterhouseCoopers (2003).

accumulation of income in the fund, or those that do not otherwise follow strictly the principle of transparency, would be willing to agree to the measures. For example, in a case where the accumulation of income is permitted (e.g. Finland), the introduction of foreign tax credits would not contribute to the neutrality between direct and fund investments, but rather would increase non-neutrality between the alternatives in favor of fund investments. Generally, it may also be argued that, from the perspective of investors, double taxation of income may be seen as a relatively insignificant factor influencing investment decisions, in particular if there are other tax advantages related to investment fund investments.[1440]

Finally, in view of the principle of subsidiarity, one could perhaps raise some doubts as whether Community measures are better suited for the aim of tax neutrality than national measures. As long as there coexist several different regimes governing the taxation of investment funds and their investors among the Member States, it is arguable that each Member State is in a better position than the Community to evaluate whether any measures of eliminating double taxation, in the context of investment fund investments, are appropriate in view of tax neutrality. Naturally, to be compatible with Community law, the measures must be equally applied to resident investors, irrespective of whether these invest in domestic or foreign investment funds. In that regard, the solution adopted by Germany in the wake of the introduction of the *Investmentsteuergesetz* may once again be referred to as an example of such measures.

8.3.3 Measures Related to Tax Enforcement

8.3.3.1 Automatic Exchange of Information

In view of taxing income from investment funds, perhaps the most serious concern of most Member States is how to be able to ensure the taxation of income received by resident investors from foreign investment funds. Usually, the Member States' tax laws impose an obligation on domestic investment funds, or paying agents, to inform national tax authorities of any income paid to, or redemptions made by, investors and/or to deduct a tax at source on income paid to investors.[1441] In contrast, the enforcement of taxation in respect of income derived from cross-border fund investments depends often solely on

[1440] It is likely that an average investor is not even aware of double taxation of income in connection with investment fund investments, and of the costs resulting therefrom.
[1441] See Chapter 6.2 of the study.

whether the income is declared by the investor. This is because of the absence of effective exchange of information between the tax authorities of the fund's residence state and the investor's residence state.[1442]

The differences in the efficiency of tax enforcement, as between investments in domestic and foreign investment funds, are harmful from the perspective of single market neutrality. To the extent that income derived from foreign investment funds may escape taxation, largely owing to inefficient information exchange between tax authorities, neutral tax treatment of domestic and cross-border fund investments cannot be maintained, even if neutrality is provided under substantive tax rules of the Member States. Whereas neutrality of tax rules of the Member States can be realized through negative integration, this is not the case as far as an effective enforcement of tax laws is concerned. Obviously, positive measures are needed to bring the Member States into co-operation in the field of tax control.

As was earlier concluded in this study, automatic information exchange is the best means of ensuring an effective taxation of income from foreign investment funds in the residence state of investors.[1443] From the perspective of the single market, only a Community-wide agreement on automatic information exchange would secure comprehensive and consistent taxation of income from cross-border fund investments within the single market, irrespective of the state of establishment of investment funds.

As explained in Chapter 6.3.2, the principle of automatic information exchange is the cornerstone of the Savings Tax Directive, the provisions of which should become applicable on 1 January 2005. Even though the Savings Tax Directive will have only a limited impact on the taxation of income from foreign investment funds, the system of tax controls introduced by it provides a convenient starting point, when considering how a more effective tax enforcement of income derived from cross-border fund investments can be achieved within the European Union. Below, the impact of the Savings Directive on the aim of establishing a functioning single market for investment funds will first be examined. Subsequently, the question will be discussed as to whether it would be possible to find a solution addressing all types of income from cross-border fund investments along the lines of the Savings Tax Directive.

Generally speaking, the inclusion of interest income received through investment funds within the scope of the Savings Tax Directive is certainly appropriate. In terms of tax control of cross-border income flows, an exclusion

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[1442] See Chapter 6.3.3 of the study.

[1443] See Chapter 6.6 of the study. See also COM(2001) 214 final, p. 15, with respect to taxing occupational pensions within the European Union.

of interest income received through investment funds would have given an unnecessary competitive advantage for fund investments over direct investments. This, in turn, might have encouraged cross-border fund investments with tax motives. Nonetheless, on account of obvious technical difficulties associated in applying the Savings Tax Directive to income received from investment funds, several exceptions to its scope have been necessary. As a result, not all interest income will be captured by the Directive, when received through investment funds as opposed to a direct investment. To that extent, the effective taxation of some part of the interest income received through foreign investment funds within the European Union will still remain dependent on self-declaration by investors, and on existing means of information exchange between the Member States.

To the extent that the Savings Tax Directive is applicable to the income, the system of automatic information exchange introduced in the Directive should level the differences in the field of tax enforcement and therefore enhance neutrality in the single market.[1444] However, from the perspective of investment fund investments, the Savings Tax Directive provides only a partial solution, as it leaves income other than interest received through investment funds outside the scope of the measures introduced. Therefore, information exchange measures under the Savings Tax Directive are not capable of resolving all the problems confronted by the tax authorities in the residence state of an investor. The restriction to interest income must naturally be seen in the light of the general scope of the Savings Tax Directive. After all, the Directive was drafted particularly with interest income, rather than specifically with investment fund investments, in mind.

The restricted scope of the Savings Tax Directive will practically divide investment funds into two categories in view of the applicability of the Directive.[1445] As regards distributing investment funds, only those whose interest-bearing investments exceed the 15 per cent threshold will be covered by the Directive. Of course, this holds true only if the Member States do avail themselves of the possibility of categorically excluding such funds from the scope of the Directive. It is, however, somewhat difficult to see why a Member State would not apply such a de minimis exception, as this is likely to lower considerably the administrative burden not only of paying agents but also of the national tax authorities. It is also obvious that a Member State would gain nothing in exchange, from the inclusion of such investment funds

[1444] As shown earlier in this study, the tax authorities in the residence state of the fund investor have very different possibilities for enforcing taxation, the effectiveness of which depends crucially on the jurisdiction in which an investment fund is resident.
[1445] It has even been predicted that the restrictions to the scope of the Directive will lead to the creation of new fund types. See De la Mettrie (2001) 21.

within the scope of the Directive. This is because the Member State's choice affects only non-resident investors receiving income from investment funds resident in the Member State, rather than resident investors in foreign investment funds resident in other Member States. In contrast, should a Member State not exercise its option, it would risk having to acquire and communicate such tax information to other Member States which it is not allowed to receive from other Member States in respect of its own residents. After all, it is the taxation of resident investors which is of main interest from the perspective of most Member States. Furthermore, the exercise of the option by Member States is likely to be welcomed not only by paying agents – because of a lower administrative burden – but also by the investment funds industry. This would allow investment funds more leeway in their investment policies, with a view to avoiding the application of the Directive to income received through them by non-resident investors.

As regards accumulating investment funds, only those whose interest-bearing investments exceed 40 per cent will be covered. In this respect, the Member States are not allowed to exercise an option of including such funds within the scope of the Savings Directive. It follows that all equity funds – as well as funds making an extensive use of derivative instruments such as hedge funds, guaranteed funds and index-tracking funds – fall outside the scope of the Directive. Moreover, in the case of accumulating funds, the 40 per cent threshold will in effect confine at least part of balanced funds outside the scope of the Directive. Unfortunately, this may induce fund investors wishing to escape the taxation in the residence state to place their money into the category of funds falling outside the scope of the Directive.[1446]

On the other hand, it must be recognized that there may arise contrary situations where not only interest income but also other types of income will in effect be covered by the Savings Tax Directive. The possibility conferred on paying agents of reporting, under certain conditions, the whole amount of a distribution rather than only the portion of interest, can potentially lead to situations where not only interest income but also other types of income will be reported (albeit without splitting out different income types). Correspondingly, in the case of redemption of fund units or shares, the reported income generally covers the whole proceeds, without splitting out different income types, paid out as long as more than 40 per cent of the assets of the investment fund are invested in debt-bearing securities. However, in this respect, Member States are allowed to exercise an option of reporting only the portion of income corresponding to the gain actually deriving from interest.[1447]

[1446] This concern is also expressed in FEFSI (1998).
[1447] See Art. 6(1)(para. 2) of the Savings Tax Directive.

As a result, situations may arise where the national tax authorities in the residence state of the investor receive information concerning not only interest income, but also other types of income received through a foreign investment fund. It has, however, been argued that information-reporting by paying agents will be restricted by the market to its most limited option, thereby covering only the portion of income actually deriving from interest, because of the negative perception which investors might have of any more far-reaching information-reporting by paying agents.[1448] In particular, Member States aiming at establishing themselves, or retaining their position, as a competitive place of establishment for international investment funds, are likely to press paying agents established within their territories towards reporting policies which are as favorable as possible from the point of view of non-resident investors. Moreover, as in the case of de minimis exceptions discussed above, Member States have little incentive to compel paying agents within their territory to comply with stricter tax reporting rules than those in other Member States, in respect of income paid out to non-resident investors. On the other hand, the benefits of a very narrow reporting from the viewpoint of underlying investors, and the higher administrative burden and costs resulting therefrom for paying agents, should be carefully weighed by Member States. It is also likely that investors wishing to escape the taxation of interest income in the residence state would prefer investment funds established in the three Member States not engaging in the information exchange, or would at least aim to channel the income through paying agents established in these Member States. Against this, the competition on grounds of the coverage of tax reporting by paying agents seems to lose some ground.

There are also differences between Member States in the amount of information required to carry out the taxation of resident investors. For example, Germany, whose tax rules work on a deemed distribution basis, would also need information about the interest earned by accumulating foreign investment funds on an annual basis, to be able to tax German investors in accordance with its tax rules. However, under the Savings Tax Directive, only distributed interest income will be covered by information exchange provisions.[1449] This would be otherwise only if the Member State of a paying agent has chosen to apply the annualisation method, in which case also undistributed interest falls within the scope of the Directive. As the decision to apply the annualisation method is in the hands of the state of the paying agent rather than the residence state of an investor, the countries taxing their

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[1448] See Larking (2001) 228.

[1449] In the absence of a distribution, there is no interest payment through a paying agent which would trigger the rules of the Savings Tax Directive.

investors on a deemed distribution basis run the risk – by relying only on the Savings Tax Directive – of not receiving all the necessary information. Basically, this is not in conflict with the aim of the Directive, since the interest income would eventually be reported to the German tax authorities at redemption of units by the German investor. Therefore, the income would eventually be subject to effective taxation in the residence state of the investor without escaping taxation in the residence state altogether. Another point is that, from the German perspective, such an outcome will not be totally in line with the aim of tax neutrality.

Another example of the inadequacies of the Savings Tax Directive is the case of switching between sub-funds of an umbrella fund by the investor. In most jurisdictions, such a transaction would be considered as triggering capital gains taxation. For the purposes of applying the Savings Tax Directive, it seems not entirely clear as to whether a switch between sub-funds constitutes an interest payment. Should this not be the case, there would remain tax planning opportunities to circumvent the application of the Savings Tax Directive, by switching units of one sub-fund – the income of which would constitute interest payment were the units redeemed – to another sub-fund, the income of which would not constitute interest payment when the units were redeemed. Although it seems consistent, for the purposes of the Savings Tax Directive, that a switch from one sub-fund to another should be treated similarly to redemption of units, it seems that such a treatment is subject to the interpretation of the term 'redemption'. In addition, there could arise some practical difficulties in this respect. For example, when switching between sub-funds of an umbrella fund, there will be no payment to the investor. Therefore, paying agents would not, as a rule, be aware of any switches between sub-funds. A further point is that the investment fund itself might be liable to report income on such a transaction.

In sum, the automatic exchange of information between Member States will generally ensure an efficient taxation of income derived from foreign investment funds in the residence state of investors, to the extent the income is covered by the Savings Tax Directive. However, the approach based on separate regulations of interest and dividend income, chosen by the Member States in the field of positive integration generally, and in the field of tax enforcement particularly, is not well suited to investment fund investments.[1450] Obviously, efficient taxation of income derived from foreign investment funds would call for an automatic exchange of information between Member States, with respect to distributions paid to – as well as capital gains realized by –

[1450] It is arguable that dealing separately with different types of income should contribute to the efficiency of negotiations between Member States. See Dourado (2000) 145.

investors, irrespective of the income type in question. In this way, the numerous predictable, and perhaps many still unpredictable, technical difficulties in the application of the Savings Tax Directive could also be avoided. Nonetheless, any measures to be enacted should optimally cover the same income, irrespective of whether received through an investment fund or directly by the investor, in order to avoid any tax-driven distortions between the two investment alternatives.

8.3.3.2 Withholding Tax System

A system which is often considered as an alternative to one based on information exchange is the withholding tax system. The original proposal for the Savings Tax Directive was also based on the idea of coexistence. Under the coexistence model, each Member State could choose either to exchange information on interest payments or to withhold a minimum tax at source on such payments. As explained earlier, Member States later abandoned the coexistence model in favor of a model exclusively based on information exchange. However, the right was conferred on three Member States – Austria, Belgium and Luxembourg – to apply the withholding tax model during a transitional period as determined in the Directive. In the following, the impact of the withholding tax system as adopted in the Savings Tax Directive on the single investment funds market will be considered. A comparison is also made between the systems of withholding tax and information exchange, as a means of an effective tax control in the single investment funds market.

The withholding tax system introduced by the Savings Tax Directive will ensure that the income covered by it will be taxed at a minimum of the applicable withholding tax. Therefore, the benefit from escaping taxation in the residence state of an investor will be reduced by the amount of the withholding tax. While the rates to be applied for the first six years (15 per cent and 20 per cent) may often be lower than the tax burden that would result from effective taxation in the residence state, the rate of 35 per cent applied thereafter will certainly be disadvantageous for many investors, as it is likely to exceed the tax burden on the income in the state of residence[1451].

Should the investor declare the income in the residence state, the withholding tax levied by the paying agent would be creditable against the tax payable therein, and, where necessary, refundable to the extent that the withholding tax exceeds the final tax liability. However, from a cash flow point of view, it would then be more advantageous for the investor to request

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[1451] See Bell (2003) 210.

an exception from the withholding tax, as provided for by the Directive. Yet another alternative would be to have the income paid out through a paying agent established either in the state of residence – in which case the Savings Tax Directive is not applicable – or at least in another Member State which does not apply the withholding tax procedure.

In view of the single market for investment funds, the system based on information exchange is obviously preferable to the withholding tax system. This is because the system based on information exchange always ensures the taxation of income in the residence state of the investor in accordance with the tax rate applicable to the income therein. By contrast, the system based on withholding tax ensures merely that the income is taxed at a minimum of a rate corresponding to the withholding tax, irrespective of whether the income is eventually declared by the investor in the residence state. Therefore, to the extent that the withholding tax rate is lower than the applicable tax rate on the income in the residence state of the investors were it properly declared, tax neutrality does not prevail.

On the other hand, it must be conceded that theoretically even the withholding tax system can be designed so as to provide neutrality between domestic and cross-border investments. This can be carried out by setting the rate of the withholding tax above the effective tax rates on the income in the Member States, and by agreeing on the procedures for crediting any excess taxes in the residence state. [1452] To be acceptable to the Member States, a revenue sharing mechanism would also be needed to ensure an acceptable division of tax revenues.

In any case, it seems that the system of automatic information exchange provides a more clear-cut solution, in accordance with which different types of income and of investors can more easily be brought within the same system. It seems also likely that, for the majority of the Member States, the system of information exchange would be preferable, in that it leaves the maximum sovereignty in income tax matters in the hands of each Member State. In particular, the decision on how to arrange the taxation of income rests entirely with the residence state of the investor. Under the system of information exchange there is also no need to alter the existing division of taxing rights between Member States.

[1452] This would compel resident investors to declare the income, because in the case of non-declaration the tax liabillity would be higher than in the case of voluntary declaration.

8.4 Conclusions

In view of the slow progress in the field of positive integration of income taxes, it must be conceded that there are very few prospects of reaching agreements which would specifically deal with investment fund investments.[1453] It is, however, more realistic to assume that some developments in the field of taxing investment fund investments may be reached in connection with positive measures of a more general scope, as the example of the Savings Tax Directive shows. Another point is that, since the enlargement of the Union to 25 Member States, it is all the more difficult to agree on positive measures in the field of direct taxation, at least as long as the requirement of unanimity prevails when deciding on direct tax issues.[1454]

When considering the need for positive integration from the perspective of the single market, it seems appropriate to distinguish between positive measures concerning substantive tax law and tax enforcement respectively. As regards the area of substantive tax law, it seems that negative integration through the case law of the ECJ would eventually result in the abolition of the remaining tax obstacles to the single investment fund market. Recent developments – particularly the remarkable introduction of the new tax regime governing the taxation of investment funds and their investors in Germany – also provide evidence of the strong impact which negative integration has on national tax laws. It seems also likely that the issue of double taxation of income in connection with investment fund investments may be resolved through negative integration. The current practice of most Member States, of exempting from taxes only domestic investment funds, seems not to be viable within the Community, as it is likely to infringe Article 56 EC enshrining the free movement of capital. This would, of course, leave untouched the economic double taxation as a result of foreign withholding taxes incurred outside the Community, which is, however, only of secondary importance in view of the objective of establishing a single market, and which in any case could only be dealt with by the Member States themselves, insofar as non-Community measures are concerned.

Conversely, when it comes to the problem of tax enforcement of cross-border fund investments, it seems inevitable that positive measures are needed. As long as taxes with respect to investments in foreign investment funds are

[1453] See also Sorgenfrei (1994) 470, who stated as long ago as a decade: "Angesichts der Probleme der Harmonisierungen direkter Steuern im Bereich der EU und der sich abzeichnenden Erweiterung der Zahl der Mitgliedstaaten dürften Harmonisierungsbestrebungen in dem Sektor der Investment-einrichtungen in absehbarer Zeit bedauerlicherweise nicht realisierbar sein."

[1454] On the necessity for the Community to relinquish the decision-making procedure based on unanimity, see, for example, Vanistendael (2000) 142-143.

not enforced as effectively as they are with respect to domestic fund investments, the possibilities of tax evasion by means of a cross-border fund investment bring the risk of undermining tax neutrality between the two investment alternatives. A system based on automatic information exchange between the Member States covering all the income, whether received directly by investors or through investment funds, would provide an efficient solution to the tax enforcement problem. In this regard, the adoption of the Savings Tax Directive may be seen as a first step towards such a system. Nonetheless, only the future will show whether another step will ever be taken.

8.5 Final Remarks and Future Prospects

It was established that, at the level of the Member States, there are still several substantive tax measures which are liable to discourage cross-border activity of investment funds as well as of fund investors. The most prominent example of tax measures discouraging cross-border activity was held to be the imposition of withholding taxes by Member States on income paid to foreign investment funds. Other examples include the confinement of certain tax benefits only to investments made through domestic investment funds. Nevertheless, in time, restrictive tax measures applied by Member States are likely to be swept away by negative integration taking effect through the interpretation and application of Community law by the ECJ.[1455]

Therefore, in the long run, a more significant problem – in view of the Community objective of establishing a single market for investment funds – was identified in the difficulties related to the tax enforcement of cross-border fund investments made by resident investors in the Member States. It was concluded that positive measures in the field of tax enforcement are required at the level of the Community. Such measures should consist of a Community-wide agreement on an automatic exchange of information between the Member States, in order to level the differences between the tax enforcement with respect, on the one hand, to domestic fund investments, and, on the other, to cross-border fund investments irrespective of the Member State in which the foreign investment fund is established.

However, it was conceded that the likelihood of achieving further positive integration in the field of tax control in the next few years may not be great. This will continue to be the case, at least as long as the requirement of

[1455] See also van Thiel (2003) 19, who states: "[…] the wider the Court defines the concept of 'unconstitutional' income tax obstacles to market integration, the less need there is for the Community legislature to act."

unanimity at the Community level is sustained when making decisions affecting direct taxation. Therefore, there may remain a substantial need for legislators at the Member State level to enact measures aimed at ensuring effective tax enforcement of investment fund investments, whether domestic or cross-border. However, in view of the prohibition of discriminatory and restrictive tax measures under Community law, finding a balance between the effectiveness of tax measures and compatibility with Community law is often difficult.

In addition, considerations relating to the competitiviness of domestic investment funds as opposed to foreign ones inevitably shrink the room of national tax policy measures. In particular, national tax measures should not make it too complicated to enforce effectively taxation both in the case of domestic and cross-border fund investments by resident investors. Deemed distribution rules may be mentioned as one example of tax measures causing enforcement difficulties particularly in the cross-border context. Even though deemed distiribution rules are often desirable, from the perspective of tax neutrality between indirect and direct investments, they can cause non-neutrality between domestic and cross-border fund investments owing to tax enforcement problems. This, in turn, is liable to distort the choice between domestic or foreign investment funds as a means of investment made by the resident investor. Therefore, it is arguable that the lack of co-operation between Member States in the field of tax control restricts the alternatives for national tax policy measures when taxing investment fund investments.

Meanwhile, Member States might wish to reconsider the way in which they have traditionally arranged the taxation of investment fund investments as a whole. Optimally, the reconsideration of the tax treatment should encompass income not only from investment fund investments, but also from direct investments, in order to ensure neutrality between the indirect and direct investment alternatives.

Here reference may be made to the Netherlands, where the taxation not only of domestic and foreign investment fund investments, but also of direct portfolio investments, was aligned with effect from 2001. Under the new tax regime, the worldwide average net value of the assets of the investor as at 1 January and 31 December of the tax year is deemed to produce a 4 per cent net return on assets. This fictitious income is taxed at a flat rate of 30 per cent, resulting in a tax of 1,2 per cent on the net assets – distributions or capital gains thereon not being taxed separately. Hence, no disctinction is made, on the one hand, between domestic and foreign investments, and, on the other, between direct and indirect investments. Of course, the new Netherlands tax regime cannot solve all the difficulties related to the tax enforcement of cross-border fund investments. For example, it is still possible for resident investors

not to declare their investments in foreign investment funds. Nonetheless, a sufficiently low effective tax burden[1456], combined with straightforward tax rules applicable in the same way both to domestic and to foreign fund investments, have their obvious merits in the context of the single market. From the perspective of resident fund investors with cross-border investments, a low effective tax burden and simple tax rules are likely to increase voluntary compliance with tax laws.[1457] From the perspective of tax administration, taxing fictitious income – in the case of cross-border investment fund investments – is also likely to be easier. From the perspective of foreign investment funds, the taxation of fictitious income avoids the possible enactment of discouraging national tax rules, compelling such funds, for example, to determine and publish tax information relevant for the Netherlands tax purposes. Finally, treatment in exactly the same way of domestic and foreign fund investments is in itself in compliance with Community law requirements, as well as with the idea of the single market.

More generally speaking, some skeptics of Community integration might also point out that any Community-wide action – whether in the form of negative or positive integration – risks undermining the competitiveness of the Community as a whole against third countries, as long as measures are restricted to intra-Community activity. Although this issue was not dealt with in this study, such arguments generally do require serious consideration on the side of the Member States. A common concern when drafting the Savings Tax Directive was the possible outflow of investments from the Community, in particular to jurisdictions known as tax-havens. It is arguable that such concern is also of significance in the case of investment fund investments, and it must be taken into account when measures are designed at the level of the Community. Even at the level of the Member States, there seems to arise an increasing need for the enactment of separate measures addressing, on the one hand, domestic and intra-Community inbound and outbound activity, and, on the other, extra-Community inbound and outbound activity.

Finally, it must not be forgotten that income tax obstacles are only one of the many constraints on the way to the single market for investment funds. Despite the UCITS Directive, cross-border marketing of investment funds has still been subject to administrative and regulatory constraints related to the

[1456] The relative tax burden is of course dependent on the actual rate of return on investment and may therefore turn out to be high in the case of low return on investment.

[1457] Again, whether tax rules are easy to understand is relative. However, here a comparison may be made to tax rules which require an investor to split-out different items of income, and then go on to request certain tax benefits attached to different items of income in the tax return. While this generally is easier to carry out in respect of income from domestic investment funds, the complications of such tax rules in cross-border transactions may increase substantially.

registration and advertising in the host states.[1458] Nonetheless, part of the problems is likely to be alleviated by the recent amendments to the UCITS Directive. In addition, there are structural and cultural constraints, which generally cannot be removed by way of Community activity, whether negative or positive integration.[1459] Such constraints may be referred to as 'natural obstacles'.[1460] It suffices to point out two examples. Firstly, domestic financial institutions may have established strong distribution networks in the course of the years, which generally can make it more difficult for cross-border promoters to gain access to a prospective clientele in a Member State. Secondly, the language differences across the Community make it generally easier and cheaper for domestic promoters than for their foreign counterparts to market their products. Although such natural obstacles are not under the direct control of policymakers, it is arguable that market trends, or changes in consumer behavior, tend to overcome natural obstacles over time.[1461]

Yet it would also be wrong to downplay the significance of removing tax obstacles on the way to the single market. In terms of philosophy of science, neutral taxation is a necessary but insufficient condition for establishing the single market for investment funds within the European Union.

[1458] See FEFSI & PricewaterhouseCoopers (2003) 5-15.
[1459] See FEFSI & PricewaterhouseCoopers (2003) 19.
[1460] Heinemann (2002) 10.
[1461] Heinemann (2002) 10.

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