Discriminatory treatment of EU pension funds making cross-border portfolio investments in bonds and shares within the European Union

Executive summary of the report supporting the complaint filed with the EC by the European Federation for Retirement Provision and PricewaterhouseCoopers
Preface

In this executive summary we provide you with an overview of our report that supports the 26 complaints that were lodged with the European Commission against 18 Member States of the European Union for infringing the free movement of capital principle. This is the first time in the history of direct taxation in the EU that so many complaints are launched on one subject on the same day.

The Member States targeted for infringements concerning both dividend taxation and interest taxation are: Austria, Czech Republic, France, Germany, Lithuania, Poland, Portugal and Slovenia.

The Member States targeted for infringements concerning only dividend taxation are: Denmark, Estonia, Finland, Hungary, Italy, Latvia, The Netherlands, Spain and Sweden.

The United Kingdom is targeted for an infringement concerning interest taxation.

In the complaints, we ask the European Commission to start infringement procedures under Article 226 of the EC Treaty because those Member States tax foreign pension funds more heavily than domestic pension funds.

The complaints establish that in those Member States pension funds that are established abroad are discriminated against as they are subject to a higher (withholding) tax on dividends and interest than domestic pension funds. We claim that such legislation breaches EU law, in particular the free movement of capital of Article 56 of the EC Treaty.

Recent case law indicates that the European Court of Justice is likely to rule in favour of EU taxpayers that have suffered discriminatory tax treatment under the laws of Member States. The infringement procedures should result in legislative amendments aimed at equal taxation of domestic and foreign pension funds.

We would like to express our gratitude to all contributors of PwC’s EU Direct Tax Group in the various Member States.

Brussels / Rotterdam, March 2006

European Federation for Retirement Provision

PricewaterhouseCoopers

Ms. Chris Verhaegen

Prof. Dr. Frank Engelen
Executive summary

1. Introduction

"The European Commission is determined to tackle tax discrimination against occupational pension funds of other Member States."

This powerful statement, made by Taxation and Customs Commissioner László Kovács, can be broken up into two observations:

- tax discrimination of pension funds is in breach of EC law,
- not all Member States are EC compliant in this respect.

The present study, performed by PricewaterhouseCoopers’ EU Direct Tax Group, seems to confirm both observations. It analyses the tax treatment of a pension fund established in one Member State and receiving dividend or interest income from investment in another Member State by that other Member State (outbound dividend or interest payments). The tax treatment of such a pension fund is compared to the tax treatment of a pension fund established in the Member State in which the payer of dividend or interest income resides by that Member State (domestic dividend or interest payments).

The analysis starts with a comparison between payments to domestic and foreign pension funds (paragraph 2). Bilateral tax treaties, which generally provide for a reduced withholding tax rate, are left out of this comparison. Furthermore the analysis in the present study is restricted to a comparison between domestic and foreign pension funds residing in other EU Member States. The tax treatment of pension funds resident of non EU States is not taken into account. Paragraph 3 contains a legal analysis. The final paragraph will provide the reader with a conclusion (paragraph 4).

2. Comparison between payments to domestic and foreign pension funds

In various Member States domestic pension funds meeting certain requirements can benefit from a special corporate income tax regime, such as a full exemption from corporate income tax or a reduced tax rate. Such a regime is – generally speaking – only applicable to qualifying retirement institutions or pension funds, often meaning that the retirement institution or pension fund should be a regulated company pursuant to the domestic civil pensions act. This preferential tax treatment often applies to withholding taxes on distributions of dividends and interest payments by a domestic corporation or debtor as well. The tax treatment of domestic pension funds may result in an exemption at source, a refund of withholding tax levied, or a credit of withholding tax levied against corporate income tax due. However, the preferential treatment of pension funds with respect to withholding taxes on dividends and interest payments does not apply to foreign pension funds.

PricewaterhouseCoopers performed a study into the taxation of domestic versus outbound dividends and interest payments to pension funds in the various Member States. In order to enlarge the accessibility for the reader, the report contains a classification of the various systems of the non-compliant Member States into three different categories:

Non-compliant countries:

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1 Taxation and Customs Commissioner László Kovács, Press release of 20 December 2004, No. IP/04/1500.
<table>
<thead>
<tr>
<th>Category 1</th>
<th>Domestic pension funds</th>
<th>Foreign pension funds</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Exemption, reduced rate, or refund/credit of domestic withholding tax / exemption from corporation tax</td>
<td>Subject to withholding tax (no exemption, reduced rate, or refund/credit)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Category 2</th>
<th>Domestic pension funds</th>
<th>Foreign pension funds</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Exemption from withholding tax / corporation tax levied (a) on a net basis, (b) on the basis of a deemed (low) yield, or (c) at a rather low corporation tax rate</td>
<td>Subject to withholding tax</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Category 3</th>
<th>Domestic pension funds</th>
<th>Foreign pension funds</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Subject to withholding tax / subject to corporation tax, but withholding tax is credited against corporation tax due</td>
<td>Subject to withholding tax / no credit against corporation tax due</td>
</tr>
</tbody>
</table>

These categories are explained in more detail below.

The first category contains tax systems according to which the domestic pension fund is exempt from corporation tax and benefits from an exemption, reduced rate, refund or credit of domestic withholding tax on dividends and interest payments, whereas a foreign pension fund cannot benefit from such an exemption, reduced rate or refund procedure. The differential tax treatment of domestic versus foreign pension funds lies in the fact that domestic pension funds are either not taxed or only taxed at a low level by the state in which the payer of dividends or interest resides, whereas foreign pension funds are taxed at a higher level when compared to domestic pension funds. The differential tax treatment of the respective pension funds ensues only from the withholding tax regime of the state in which the payer of dividends or interest resides.

The second category contains tax legislation according to which the domestic pension fund is not exempt from corporation tax, but does benefit from an exemption from domestic withholding tax on dividends and interest payments, whereas a foreign pension fund cannot benefit from such an exemption from withholding tax. The following aspects of this differential treatment can be distinguished:

i. The domestic pension fund is exempt from dividend withholding tax, whereas the foreign pension fund cannot benefit from an exemption, refund or credit of withholding tax. In this comparison the corporation tax position of the domestic pension fund in the state in which the payer of dividends or interest resides, is left aside;

ii. The domestic pension fund is exempt from dividend withholding tax but subject to corporation tax, whereas the foreign pension fund cannot benefit from an exemption, refund or credit of withholding tax. As a result, the foreign pension fund has to pay tax at an earlier point in time (at the moment of dividend distribution) than the domestic pension fund (upon filing of the corporate income tax return). As a result the foreign pension fund suffers a cash flow disadvantage;

iii. The effective tax burden on the domestic pension fund is in the end lower than the tax burden on the foreign pension fund with respect to the dividends and interest paid to it. This differential effective tax burden can be caused by the fact that the corporation tax due by the domestic pension fund is (a) calculated on the basis of the net-income of the pension fund (i.e. costs are tax deductible), (b) calculated on a basis which differs from the tax basis for withholding tax purposes, or (c) calculated on the basis of a lower corporate income tax rate when compared to the withholding tax rate.

The third category contains tax systems according to which the domestic pension fund is not exempt from corporation tax and does, in general, not benefit from an exemption from domestic withholding tax on dividends and interest payments. However, the domestic pension fund is
allowed to credit the withholding tax against the corporation tax due, a possibility not available for foreign pension funds since the latter are not subject to corporation tax in the state in which the payer of dividends or interest resides. As a result, the effective tax burden on the domestic pension fund may in the end be lower than the tax burden on the foreign pension fund with respect to the dividends and interest paid to it. The lower effective tax burden is caused by the fact that the corporation tax due by the domestic pension fund is calculated on the basis of the net-income of the pension fund or by special corporation tax regimes applicable to domestic pension funds, whereas foreign pension funds are taxed on the gross amount of the dividend and/or interest actually received.

Our survey shows that 17 Member States effectively subject outbound dividends paid to EU pension funds to a higher level of taxation than domestic dividends paid to domestic pension funds. Furthermore, it shows that 9 Member States effectively subject outbound interest payments to EU pension funds at a higher level of taxation than domestic interest payments to domestic pension funds. In paragraph 3 (‘Legal analysis’) we will take the view that these Member States are not EU compliant.

3. Legal analysis

In the absence of harmonisation direct taxation has remained essentially within the competence of Member States. However, Member States must exercise that competence consistently with Community law. ²

Article 12 EC states that, within the scope of application of the EC Treaty, and without prejudice to any special provisions contained therein, any discrimination on grounds of nationality shall be prohibited. Article 12 EC does not only prohibit direct discrimination on grounds of nationality, but also indirect discrimination on grounds that effectively lead to that result. ³ Discrimination on the basis of residence can be regarded as such a ground. ⁴ This general ban on discrimination has been laid down into several fundamental freedoms which the Member States of the EU must comply with. One of these fundamental freedoms is the free movement of capital, laid down in Article 56 of the EC Treaty, which provides for a prohibition on all restrictions on the movement of capital as between the Member States. Article 56(1) EC determines:

“Within the framework of the provisions set out in this Chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited.”

All restrictions on the movement of capital being principally prohibited, a Member State is not allowed to treat investments by domestic investors more favourably than investments by foreign investors. ⁵ Exceptions to this rule, specifically on the basis Articles 58(1) and 58(3) EC, are rare.

Since Article 56 EC is applicable to the ‘movement of capital’ the first question arising is whether portfolio investments by a resident of one Member State in shares in a corporation or debt claims on a resident of another Member State and the returns on these investments can be qualified as movement of capital. According to settled case law, this question has to be answered affirmatively. In particular the Verkooijen, Lenz and Manninen ⁶ cases undoubtedly lead to this conclusion.

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² See for example case C-35/98 (Verkooijen).
³ See already ECJ 12 February 1974, case 152/73 (Sotgiu), at 11.
⁴ See for example case C-279/93 (Schumacker), at 26-29, and case C-107/94 (Asscher), at 38-39.
⁶ See ECJ cases C-35/98 (Verkooijen), C-315/02 (Lenz) and C-319/02 (Manninen).
In general, the ECJ takes the view that discrimination arises from the application of different rules to comparable situations or the application of the same rules to different situations. Most of the cases of more favourable tax treatment of outbound dividends and interest payments are restricted to domestic pension funds that have to meet certain criteria laid down in the national law of the Member State concerned. The differential treatment of a foreign EU pension fund as compared to a domestic pension fund therefore results in the application of different rules to similar situations. After all, non-resident pension funds are often worse off than domestic pension funds because the withholding tax to which they are subject results in a higher tax burden in the Member State of investment as compared to domestic pension funds. This difference in tax treatment of domestic versus foreign EU pension funds can be qualified as (indirect) discriminations on grounds of nationality. This view is supported by the *Fokus Bank* judgment of the EFTA Court, the judgements of the ECJ in the *Gerritse* case, the *Metallgesellschaft & Hoechst* cases, the *Bouanich* case and a judgment from the Dutch Gerechtshof of 's-Hertogenbosch.

No justification can be successfully put forward for the discriminatory tax measures at issue. Hence, these measures are in breach with Article 56 EC. In our view the state which levies withholding tax on outbound dividends or interest should not be able to claim that the state of residence of the foreign pension fund should credit or refund the withholding tax levied by the state first mentioned against corporation tax (possibly) due by the foreign pension fund in its state of residence. This view is supported by the considerations of the EFTA Court in the *Fokus Bank* judgment in paragraphs 31 and 32.

4. **Conclusion**

The differential treatment of (outbound) dividends and interest paid to foreign pension funds as compared to (domestic) dividends and interest payments to local pension funds constitutes unjustified discrimination. As a result, the tax withheld at source on dividends and interest payments to foreign pension funds infringes the EC Treaty.

We recommend the European Commission to start an infringement procedure pursuant to Article 226 EC against the Member States treating domestic and foreign pension funds differently.

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7 Case C-279/93 (*Schumacker*), under 30.
8 Some national measures leading to a less favourable tax treatment of outbound dividends and interest payments are of a general nature and are not confined to legally defined ‘pension funds’.
9 EFTA Court 23 November 2004, case E-1/04 (*Fokus Bank ASA*).
10 ECJ case C-234/01 (*Gerritse*).
11 ECJ cases C-397/98 and C-410/98 (*Metallgesellschaft Ltd and Others*).
12 ECJ case C-265/04 (*Bouanich*).
13 Please note that the Dutch tax authorities decided to appeal to this decision. This means that the Dutch *Hoge Raad* will rule on this matter in last instance.
The Member States that are in our view not EU compliant are identified with an X in the table below.

Table: Member States that are not EU compliant

<table>
<thead>
<tr>
<th>Country</th>
<th>Taxation of dividends paid to pension funds</th>
<th>Taxation of interest paid to pension funds</th>
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<tbody>
<tr>
<td>Austria</td>
<td>X</td>
<td>X</td>
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<tr>
<td>Czech Rep.</td>
<td>X</td>
<td>X</td>
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<tr>
<td>Denmark</td>
<td>X</td>
<td>-</td>
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<tr>
<td>Estonia</td>
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<tr>
<td>France</td>
<td>X</td>
<td>X</td>
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<tr>
<td>Finland</td>
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<td>-</td>
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<tr>
<td>Germany</td>
<td>X</td>
<td>(X)</td>
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<tr>
<td>Hungary</td>
<td>X</td>
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<td>Italy</td>
<td>X</td>
<td>-</td>
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<td>Latvia</td>
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<td>Lithuania</td>
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<td>Netherlands</td>
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<tr>
<td>Poland</td>
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<td>Portugal</td>
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<td>Slovenia</td>
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<tr>
<td>Spain</td>
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<td>-</td>
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<tr>
<td>Sweden</td>
<td>X</td>
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</tr>
<tr>
<td>UK</td>
<td>-</td>
<td>X</td>
</tr>
</tbody>
</table>

14 Withholding tax on interest payments to non-resident pension funds only applies under very specific circumstances.
PricewaterhouseCoopers

PricewaterhouseCoopers provides industry-focused assurance, tax & HRS and advisory services for public and private clients. PricewaterhouseCoopers is a truly global organisation with member firm offices in 769 cities in 144 countries. With a combined headcount of more than 130,000, PwC firms rank amongst the world's leading employers of highly skilled, professional people. Aggregated revenues in fiscal year 2005 were USD 20.3 billion, including expenses reimbursed by clients. Our clients range from the world's largest and most complex organisations to some of its most innovative entrepreneurs.

The EU Direct Tax Group (EUDTG), a network of EU law experts, is part of PricewaterhouseCoopers’ International Tax Structuring Network. The EUDTG assists organisations, companies and private persons in benefiting from EU developments in their specific facts and circumstances. It assists taxpayers in their actions towards tax authorities as well as in proceedings before local courts and the European Court of Justice.

European Federation for Retirement Provision

The European Federation for Retirement Provision is the EU level umbrella organisation of national associations of pension funds and similar institutions for retirement provision. EFRP’s membership spreads throughout the European Union and beyond and mainly consists of institutions for occupational (2nd pillar) retirement income - IORPs.

The EFRP wants to promote occupational pensions in the EU that:
- are affordable for large sections of the population;
- help to maintain living standards in retirement;
- provide a degree of intra- and inter-generational solidarity; and
- are administered through funding institutions.

Those IORPs must be able to operate throughout the European Union on the basis of a single license, taking into consideration the principle of subsidiarity and national diversity. 73 million EU citizens are covered for their occupational pension plan by EFRP Member Associations and their assets managed for future occupational pension payments amount to €2.670 billion (2003).

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15 EU Member States: Austria, Belgium, Denmark, Finland, France, Germany, Hungary, Ireland, Italy, Luxembourg, Netherlands, Poland, Portugal, Spain, Sweden, UK.
Non-EU Member States: Croatia, Guernsey, Iceland, Norway, Switzerland.