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Discriminatory Withholding Tax for Foreign Investment Funds

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Abbreviation list

AG	Advocate General
AIF	Alternative Investment Fund
AuM	Assets under Management
CMU	Capital Markets Union
DTC	Double Taxation Conventions
EU	European Union
ECJ	European Court of Justice
FBI	Fiscal investment Institution
PSD	Parent Subsidiary Directive
SICAV	Société D'Investissement à Capital Variable
TFEU	Treaty of the Functioning of the European Union
UCITS	Undertakings for the Collective Investment of Transferable Securities
US	United States of America
WHT	Withholding Ta

1. Introduction

1.1 Investment Funds Generally

Institutional and individual investors who commit their money to the investment fund have emerged as dominant holders of financial assets and increasingly work as a means of channeling private saving into the economy as well as providing liquidity and funding for corporations. Since 2008 and the outbreak of The Financial Crisis there has been steady growth in the Assets under Management (AuM) of the European institutional investors and paving the way for investment funds products. In 2017 assets invested in open-ended investment funds amounted to EUR 14,3 trillion. The appeal of investing into an investment fund may be explained by the fact that they provide individual investors without sophisticated market knowledge in a way to invest and have professional investment managers handling their portfolio.¹ More importantly, investment funds provide small investors with portfolio diversification, hence in theory reducing risks related to investments in single securities.² Firstly, this introduction provides an overview of investment funds, structures, characteristics and describes the tax challenges before moving on to analyze the issues of discriminative treatments of investment funds with regards to withholding taxes and the fundamental freedoms. The structure of an investment funds is illustrated below:

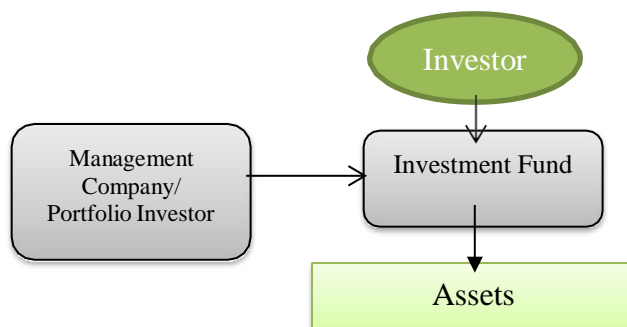


Figure 1. Structure of Investment Funds

¹ Tomi Viitala, Taxation of Investment Funds in the European Union, p 1.

² Supra, p 1.

Investment funds are operated by financial intermediaries who use the funds invested by the investor to acquire and manage financial assets.³ The investment management company (IMC) or fund manager is the entity or a person who usually creates and manages the functions of the fund. To break it down to basics, the aim of the IMC is to collect money from institutional and individual investors, pool the money in the fund and invest the cash funds according to the investment strategy of the fund in assets based on investment policies of the fund and national legislations.⁴ The management of the fund is either done through an external IMC or by the fund itself where its legal form allows internal management.⁵ For example, in Luxembourg they have SICAVs (investment funds), which are established in corporate form and these must be either managed by IMC or be self-controlling entities.

When management is undertaken internally, the functions of the fund manager takes on the daily operations of the fund itself. Hence, the investment fund carries out business activity by itself and the investment fund is classified as a legal entity. External management on the other hand has raised uncertainty in practice. Some authors argue that the fund or the fund's investors themselves do not carry out management activity and in these cases should be considered as two separate entities.⁶ However, from the perspective of this thesis, the distinction is usually solved through the domestic company law.

1.1.1 Classification of investment funds

Investment funds can be classified by its objective or administrative policy.⁷ When classified by its objective, the fund is determined based on the fund vehicle investment policy and risk and return profile, which are policies that highlight the risks concerned with an investment in the fund and the return an investor may should expect to achieve.⁸ One such example is equity investment fund, which invests its assets in public shares of companies listed on the stock exchange. The income earned by the equity fund's assets

³ Tomi Viitala, *Taxation of Investment Funds in the European Union*, p 17.

⁴ *Supra*, p 18.

⁵ Kogut, *Tax Obstacles to Cross-Border Investments Through Private Equity Investment Funds*, p 10.

⁶ *Supra*, p 11.

⁷ Tomi Viitala, *Taxation of Investment Funds in the European Union*, p 12.

⁸ *Supra*, p 20.

consist partly of dividends paid out by the companies in which the fund invests in. The other part of income is generated through realized and unrealized capital gains, reflecting an increase in the value of the underlying shares.⁹ Private equity investment funds or alternative investment funds, on the other hand, have very different objectives, risks and issues with valuation and complexity compared to a normal investment fund investing in public equity investments. This shows the breadth and differences among investment funds available. When classification is based on the funds administrative policy a distinction can be made between open-ended and closed-ended investment funds.¹⁰ Open-ended investment funds do not have an upper limitation on how many shares can be issued.¹¹ When an investor purchases shares in an open-ended fund, then more shares are issued. Similarly, when an investor sells his or her shares, the shares are taken out of circulation. Closed-ended funds have a finite number of shares issued, therefore, in order for an investor to buy shares in the fund he or she must purchase shares from other investors willing to sell their shares in the fund. Another important factor concerning the closed-ended funds is the different use of leverage when investing. When using debt, the investment fund loans money to invest more in the fund than 100% of the money received from investors.

1.1.2 Regulation of investment funds

One of the biggest challenges facing the European investment fund market is the sheer breadth and variations of investment funds available that are classified differently, governed by different jurisdictions and ultimately create confusion between investors. To reach a solid level of harmonization of the investment funds, improve transparency and competition and protect investors, the Commission has adopted the UCITS V directive (Undertakings for Collective Investment in Transferable Securities) 2014/90/EU.¹² The objective of the directive is to allow for open-ended investment funds to be subject to the same regulation in every Member State. To achieve this, the funds or its management

⁹ Tomi Viitala, *Taxation of Investment Funds in the European Union*, p 21.

¹⁰ *Supra*, p 23.

¹¹ *Supra*, p 23.

¹² Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS).

company have to apply for UCIT authorization to be classified as an UCIT fund. Once approved, the fund receive an “European passport”, which allows them to market its investment fund product throughout the EU without having to apply any further authorization in different Member States.¹³ Even though UCIT status allow for the fund to become available to all European member state investors, the fund may be liable to uphold potential stricter investor protection rules in under certain domestic laws.¹⁴ However, such rules must apply without discrimination. It is also important to notice that the UCIT Directive does not regulate taxation of investment funds.

1.1.3 Tax treatment of Investment Funds

The taxation of funds is a key issue for the funds and their management companies, as it affects the attractiveness of investment funds and the lure to pull in potential investors to invest in an fund is often based on both an analysis of the investment and its tax purposes. When considering the tax consequences on investments made through investment funds (asset, fund, investor) there are two capital flows that should be analysed: dividends flowing from the investment to the investment fund and dividends flowing from the investment fund to the investor. A fund may be liable to pay tax on income or gains received from its assets (bonds, equity, etc.). This income is usually taxed at the level of the asset, and then on distribution of income or gains by the target companies to the fund; and by the fund to the fund’s investors; and then, in addition, the investors themselves may have taxation liabilities on their fund returns, in theory there may be several levels of taxation applied on returns received by fund investors.¹⁵ Whereas maximum three tax consequences would apply to a person holding shares directly in a company instead of through a fund (at the level of the company, shareholder and possibly on distribution of income to the shareholder).¹⁶ Therefore, it is clear that from the tax perspective the investor via the fund would be in a less advantageous position. To avoid this kind of difference, Member State apply the concept of tax neutrality.¹⁷ That means the investor via a fund would bear the same tax burden as the investor who would invest directly. In

¹³ Kogut, *Tax Obstacles to Cross-Border Investments Through Private Equity Investment Funds*, p 7. Electronic access: https://www.maastrichtuniversity.nl/sites/default/files/master_research/Thesis_Kogut_i6051085.pdf.

¹⁴ *Supra*, p 7.

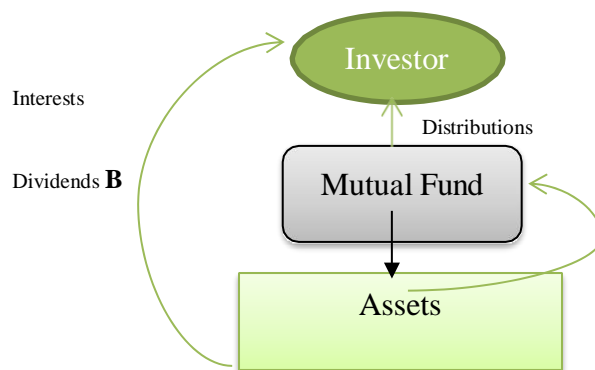
¹⁵ *Supra*, p 14.

¹⁶ *Supra*, p 15.

¹⁷ *Supra*, p 15.

order to achieve tax neutrality Member State have the possibility to apply either a separate entity principle (Company type fund) or a transparency principle (Contractual type fund).

The following scheme attempts to illustrate these principles further.



1.1.3.1 Representation of investment structure in the domestic case.

Figure 2.1 provides a representation of the domestic case. The fundamental distinction has to be made between situation X and B. In case X, funds are taxed according to the separate entity principle, which means that both the fund and investor are liable to separate income tax. In this case, the income accrued from investments are subject to twice-over income tax burden.¹⁸ Thus, in order to neutralize tax, Member States often provide different tax incentives - for example, the fund will be exempt from the tax - or will be subject to a 0% corporate tax - or provide possibility for the investor to off-set the withholding tax from their individual or corporate income tax.¹⁹ In Case B, the fund is taxed according to the transparency principle. That means the fund is ignored for tax purposes and the income is distributed directly to the investor.²⁰ Thus, the tax assessment at the fund level becomes irrelevant.

1.1.4 Investment Income Governed by different tax Jurisdiction

In a domestic situation Member States have structured their domestic laws in a way different level of taxation do not create double or non-double taxation, so that above

¹⁸ Markus Hammer, Taxation of Income from Domestic and Cross-Border Collective Investment, p 22.

¹⁹ Supra, p 22.

²⁰ Supra, p 22.

mentioned market neutrality is maintained and the investor's option between direct investment and alternative investment is as tax neutral as possible. Taxation issues arising from cross-border context are as far more complex than in domestic situation. This is due the fact that not only does the investor's state of residence have the right to tax on income, but the source state where the income arises may also be entitled to exercise the income received by the non-resident investor.

In a cross-border situation the tax matters are usually associated to the concept of source and residence, as they present the main factors for allocation of taxing rights.²¹ Based on the principle of tax sovereignty, Member States have option to tax residence according to the residence taxation and non-residence based on source taxation principles. The main rule is that residence country taxes on worldwide income based on the ability to pay principle and source country taxes on the profits arising from in territorial base.²²

In the situation where the investment company (source state) is established in a different jurisdiction than the investment fund (residence), the source state is generally interested in claiming WHT for the capital generated in its country. Thus, Member States often establish different treatment between capital flows through investment funds in domestic and non- domestic situations. Furthermore, both countries have their own classification on investment funds in order to be subject to WHT tax exemption or reduce rate. Even if the double taxation is eliminated and tax neutrality achieved the cross-border different treatment is still maintained.

The uncertainty surrounding the tax treatment, especially in cross-border situations, tend to trigger tax issues, such as discriminations and restrictions to fundamental freedoms that may arise where such investments are cross-border, both within EU and in scenarios involving third party countries. Through the Capital Markets Union (CMU) project, the Commission together with MS have identified national and regulatory barriers: 1) Burdensome withholding tax (WHT) relief procedures and 2) barriers to cross-border distribution of investment funds.²³ These issues are currently highlighted by number of pending case laws. Particularly, Denmark²⁴ and the Netherlands²⁵ have referred questions

²¹ Ben Terra, *European Tax Law*. Sixth Edition, p 941.

²² *Supra*, p 942.

²³ European Commission, Report from the Commission to the Council and the European Parliament: Accelerating the capital markets union: addressing national barriers to capital flows. Brussels (2017), p 2.

²⁴ Case C-480/16, *Fidelity Fund*.

²⁵ Case C- 56/17, *Dutch Köln-Aktienfonds*.

to the primary ruling in order to assess whether the provisions from domestic law, under which dividends distributed by a resident to a foreign mutual investment fund, were taxed differently comparing to the residence investment fund.

1.1.4.1 Danish domestic law

Under the Article 65 (1) of the Danish Law on WHT, dividends distributed by a resident company to a foreign investment fund were subject to withholding tax at a rate of 25%.²⁶ Dividends distributed to a domestic investment funds (UCITS) were tax exempted, if the latter benefitted from the Article 16 C fund status, by making a minimum distribution to its shareholders; and by having tax residence in Denmark.²⁷ As a result, taxpayers claimed that different tax treatment is unjustifiable restriction to the free movement of capital and requested a refund of the tax levied.

Investment funds in the present case were subject to the UCIT Directive. Therefore, parties argued if those special requirements (residence, distribution) imposed by Denmark to the non-resident investment funds (UCITS under each country domestic law), would make the Directive 85/811 and fundamental freedoms meaningless.²⁸ As the UCITS funds are established under the legislation of each Member State, the Supreme Court was unsure to what extent Member State may levy specific requirements for investment funds, such as distribution requirement in the light of discriminatory dividend taxation.²⁹ Furthermore, the Supreme Court found that the issue have not been discussed directly before and thus it referred questions to the primary ruling.

1.2 Aim

The issue of taxing investment funds has resulted in decreased amount of legal certainty. Lack of legal certainty reduces the attractiveness of business and investment environment. The importance of the matter is illustrated by the amount of claims made by foreign investment funds. More than 3000 funds have claimed a full refund of the dividend WHT. As the claims concern interpretation of fundamental freedoms, both Denmark and Netherlands have admitted that there is no full clarity how to assess whether the domestic tax treatment for foreign investment funds is discriminatory.

²⁶ Case C-480/16, Fidelity Fund.

²⁷ Case C-480/16, Fidelity Fund.

²⁸ Case C-480/16, Fidelity Fund.

²⁹ KPMG, AG Opinion on Denmark`s WHT on dividends paid to foreign investment funds. Electronic access: <https://home.kpmg.com/lu/en/home/insights/2018/01/withholding-tax-dividends-paid-foreign-investment-funds.html>.

The aim of the thesis is to examine in what terms of comparability the European Court of Justice has developed in its recent case law in determining whether the restrictive dividend WHT is discriminatory for foreign investment funds. Thesis introduces the current legal situation in two countries. Denmark and Netherlands. Both countries have been dealing with taxation cases from administrative courts until to the end of Supreme Court. Furthermore, both countries have referred similar rulings to the European Court of Justice.

The following questions will be assessed in making the assessment:

- How is the comparability assessed in regards of alternative investment funds?
- Must the offsetting of withholding tax must be taken into account when determining the final tax burden of the shareholder?

1.3 Method and material

The analysis is based on the legal literature studies and traditional sources of law. The material used in the thesis are EU primary law (TFEU) and secondary law, as well as other sources of law such as academic articles and books. Strong focus is on case law of European Court of Justice and the domestic case ruled by the Netherlands Supreme Court. Academic articles used in this thesis are collected from tax journals, such as IBFD and EC Tax Review. Most materials are found through following data bases and searching platforms: Kluwer Online, IBFD Tax Research Platform, HeinOnline as well Google Chrome.

1.4 Delimitation

Due the wide scope of withholding taxes the thesis will be limited to the aspects of withholding tax on dividend payments from the source state perspective. Further, justifications and proportionality will be only briefly discussed.

Taking into consideration the complexity of investment funds and its relation with dividends taxation, the main focus will be European Union law.

1.5 Disclaimer

The author is aware that the legal situation has been changed on 21. of June 2018 due to the ECJ's ruling on the pending issue analysed in this thesis, but will present the issues at the time pending on the final seminar (28.05.2018) for this Master thesis.

2. Fundamental Freedoms and Withholding Tax

2.1 Effected Freedoms

The founding of the TFEU economic integration of the Member States and the creation of an internal market are the most important objectives of the EU. These objectives are achieved by establishing an internal market and monetary union. For that purpose, the EU has general non-discrimination provision, Art 18 TFEU, and the five fundamental freedoms, under which obstacles on the free movement of goods, persons, services and capital preventing this development must be removed.³⁰ The scope of fundamental freedoms is different as each of them has their own field of application.³¹ Article 49 of the TFEU prohibits restriction on the freedom of establishment between MS. In order to determine whether the national legislation in question is covered by the Treaty provision on fundamental freedoms, the purpose of the legislation concerned must be taken into consideration.³² In the present case, as can be inferred from the Opinion of AG in Fidelity Fund, the holdings of Fidelity Funds and NN (L) SICAV in Danish companies were acquired solely on purpose of generating future income and without influencing the management and the control of the company.³³ Furthermore, UCIT Directive established a restriction under which a maximum of 10 per cent of a fund's net assets may be invested in securities from a single issuer.³⁴ Based on those facts, one could argue that application of free movement of establishment could be ruled out. The reasoning can be deferred from the ECJ decision held in case *Baars*,³⁵ In this case the court formulated criteria "definite influence" as a principle in assessing whether or not freedom of establishment applies (Baars doctrine).³⁶ Following the ECJ case law there are two alternative approaches how the "definite influence" should be applied: factual situation and taking into account the purpose of the legislation. Firstly, the ECJ considers actual shareholding as a decisive factor. This Baars doctrine has been

³⁰ Lang. Pistone, Introduction to European Tax Law on direct taxation, p 61.

³¹ Supra, p 61.

³² Opinion of AG Mengozzi, Case C-480/16, Fidelity Funds, p 17.

³³ Supra, p 22.

³⁴ Loader. David, Fundamentals of Fund Administration, p 28.

³⁵ Case C-251/98, Baars.

³⁶ Supra, p 22.

applied by the ECJ in several cases, for example in the case *Aberdeen*.³⁷ In this case, the court found that as the company established in Luxembourg had a shareholding in the Finnish company and therefore exercised some control over the company's decisions and activities, made it comparable to the Finnish company. As such a comparable Finnish company was exempt from tax on dividend payments, it was clear that this was a breach of the freedom of establishment.³⁸

ECJ has not always been consistent with its analysis. That means that not always has the factual situation been interpreted together with the purpose of the legislation at hand. Nevertheless, the ECJ has stipulated that the legislation could apply both to a shareholder with decisive influence and a shareholder, who does not have decisive influence. In this case, only the free movement of capital may apply.³⁹

Article 63 of the TFEU establishes that all restrictions on the movement of capital between Member States and third countries shall be prohibited.⁴⁰ The TFEU does not define terms "movement of capital" or "payments". In case of *Verkoijen*, the ECJ defined capital movements as financial operations dealing with the investment of funds.⁴¹ ECJ referred to the nomenclature of the capital movement set out in Annex I to Council Directive 88/361/EEC, which constitute non-exhaustive list of the operation which consists capital movements.²⁷ Even though the Directive has been substituted by the Treaty of Amsterdam, it has the still same effect as it did before the new Treaty.⁴² In the present case the national legislation at issue concerns the tax treatment of dividends received by UCIT funds, thus it can be concluded once again that the issue falls within the scope of free movement of capital. Thus, the present study, given the nature of investment funds, will focus mostly on the free movement of capital.

2.2 Difference in treatment

In order to determine whether a tax provision consists restriction to the movement of capital, it is necessary to examine whether the application of the Article 63 TFEU has a restrictive effect on investment funds.⁴³ In order to gain UCIT status under the Danish law latter have to meet residence and distribution requirement. Only the UCITS with tax residence

³⁷ Case C-303/07, *Aberdeen*.

³⁸ Case C-303/07, *Aberdeen*.

³⁹ Rene van Eldonk, *Freedom of establishment versus free movement of capital: continuing uncertainty*.

⁴⁰ Antonio Calisto Pato, *EC Law and Investment Funds: The Aberdeen Case*, p 118.

⁴¹ Case C-35/98, *Verkoijen*, p27.

⁴² Case C-386/04, *Stauffer*, p 22.

⁴³ Opinion of AG Mengozzi, Case C-480/16, *Fidelity Funds*, p 24.

in Denmark may be eligible for WHT exemption.⁴⁴ The fact that a more favorable tax treatment applies to investment funds which meet either residence or distribution requirements under the source state of law, places foreign UCITS in a less favorable position. At first, different WHT treatment on dividends may discourage foreign investment funds from investing abroad; and secondly, it may discourage investors to acquire shares in a non-resident investment fund.⁴⁵

2.2.1 Distribution requirement

Investment funds could be classified either as accumulation funds or distribution funds. Distribution fund pays regular distributions to their shareholders. This requirement is regulated under the domestic law of each MS. That means in order to qualify as a specific investment fund, it must distribute of its annual taxable income to the investor. Non-satisfaction of the distribution requirement results in a loss of “specific” fund status. This practice is very common between Member States. Examples, could be triggered from the present cases, where dividends paid to Danish UCITS were exempt from withholding tax, only, if the latter made set minimum distribution to its investor. Or in order to be subject to Dutch FBI regime, the investment capital have to be distributed within the eight months after book year end. Investment based on countries without WHT on dividends may suffer WHT changes to avoid double taxation (credit method). Thus, the distribution requirement may treat foreign investment funds or investors differently.

2.3 Withholding taxes and its relationship with the fundamental freedoms

The general principle of free movement of capital is defined in Article 63 of the TFEU. This Article stipulates that all restrictions on the movement of capital between Member States (and third countries) shall be prohibited.⁴⁶ Due to the strictly drafted prohibition of restrictions on capital movements between MS, the grounds for justifying restrictive national tax measures are particularly important.⁴⁷ Article 65 (1) of the TFEU provides an exemption to the prohibition. This Article allows MS: *“to apply the relevant provisions of their domestic laws which distinguish between taxpayers who are not in*

⁴⁴ Supra, p 25.

⁴⁵ KPMG, AG Opinion on Denmark`s WHT on dividends paid to foreign investment funds. Electronic access: <https://home.kpmg.com/lu/en/home/insights/2018/01/withholding-tax-dividends-paid-foreign-investment-funds.html>.

⁴⁶ Antonio Calisto Pato, EC Law and Investment Funds: The Aberdeen Case, p 118.

⁴⁷ Tomi Viitala, Taxation of Investment Funds in the European Union, p 245.

*the same situation with regard to their place of residence or regard to the place their capital is invested.*⁴⁸ Following the reasoning of the ECJ, the derogation from the fundamental principle of free movement of capital has to be interpreted strictly, so that the scope could not be determined unilaterally by each Member States, without any control by the EU.⁴⁹ Furthermore, the derogation of Article 65(1) of the TFEU is itself limited by the Article 65 (3) of TFEU, which states that the provision referred to Article 65 of the TFEU shall not constitute discrimination or a restriction of free movement of capital.⁵⁰ Thus, the distinction must be made between the difference in treatment (Article 65(1)) and between the discrimination prohibited by Article 65(3). Following the ECJ case law, the restriction on the free movement of capital is only acceptable if the difference in treatment which are not objectively comparable or justified by the overriding reasons of public interest.⁵¹ The following part of the thesis will look into the evolution of the case law of the free movement of capital. The aim is to find the answer are resident and non-resident in a comparable situation regarding dividend payments. For that purposes some of the comparability terms established in the case law that could have a bearing on investment funds, are presented. There are series of cases concerning outbound dividends/interests, but only the most important are discussed. (when are WHT breach of Fundamental freedoms).

It is settled case law that foreign taxpayers cannot be subject to a higher tax burden compared to domestic residents.⁵² Member States may tax neutralize discrimination through bilateral treaties, but they are still held accountable for guaranteeing non-discrimination. As stated in the *Amurta* case, tax neutralization or specific tax-credits have to be drafted into the tax treaty.⁵³ Member State that discriminates in a cross-border situation cannot rely on the other contracting state's domestic rules in order to eliminate the discrimination. In cases where the source state chooses to tax dividends, the responsibility of TFEU compatibility taxation rests on this state.⁵⁴ Thus, if the tax credit is not stipulated in a tax treaty signed by the source state, there is no compensation for withholding tax discrimination in the legal system of the discriminating state. According

⁴⁸ Article 65 (a) TFEU.

⁴⁹ Catherine Barnard, *The Substantive Law of the EU*, p 546.

⁵⁰ Case C-319/12, *Manninen*, p 28.

⁵¹ Case C-190/12, *DFA Investment Trust Company*, p 57.

⁵² Opinion of AG Jaaskinen, *Joined Cases C-10/14, C-14/14 and C-14/17, Miljoen and others*.

⁵³ Case C-379/05, *Amurta*.

⁵⁴ C. Maisto, *Taxation of Intercompany Dividends Under Tax Treaties and EU Law (2012)*, *Journals IBFD*. p. 28.

to the ruling in case *Commission v Italy*, the tax neutralization is successfully implemented, if the tax treaty grants a full credit for foreign WHT and hence allowing foreign taxpayers to be fully compensated.⁵⁵

On 25th of June 2015, Advocate General Jääskinen delivered an opinion in joined cases *Miljoen and others*, where he stipulated that the state of residence is not required to grant a credit for more than the amount of the domestic income concerned.⁵⁶ Moreover, according to the AG, it is the source state's responsibility to ensure that full tax neutralization is achieved.⁵⁷ Neutralization could be achieved through bilateral treaties, but since they are always coordinated with national legislation in mind, it can be argued, that tax neutralization of a discrimination is difficult to reach as domestic laws evolve and the majority of the cases fall outside the scope and definitions of these treaties.⁵⁸ The court has stated that in some cases that where continuous discrimination exists, that those restriction of the free movements of capital may in rare circumstances be justified and be in the public interest or due to the coherence of the tax system. However, so far member states have been in most cases been unsuccessful in convincing the CJEU that they have had circumstances that allowed for justification and hence discrimination. The proceedings have granted the CJEU with a very strict reputation in measures concerning different cross-border tax treatment.

2.3.1 Netherlands – Supreme Court Decision

It is clear from the settled case law that Member States cannot treat non- residence investors disadvantageously compared to residents in the case of dividend payments. Another challenge is the determination of what constitutes a taxation disadvantage as new issues constantly arise both lawmakers and academia struggle to keep up. On July 2015, the Dutch Supreme Court ruled that a foreign investment fund could not obtain a refund of a Dutch dividend WHT that the fund incurred on its dividend income, as the court argued it is not comparable to a Dutch Fiscal investment Institution (Dutch FBI). Under the Dutch law, a Dutch FBI is subject to a 0% corporate tax rate provided that it meets certain criteria. A FBI needs to

⁵⁵ Case C-379/05, *Amurta*, p 28.

⁵⁶ Opinion of AG Jaaskinen, *Joined Cases C-10/14, C-14/14 and C-14/17, Miljoen and others*, p 97.

⁵⁷ *Supra*, p 97.

⁵⁸ *Supra*, p 97.

maintain a 100% payout of its pro rata profits within a set of time. Moreover, regarding its redistribution requirement there are both quantitative and qualitative aspects.⁵⁹ Under the quantitative requirement, the profits must be distributed within an eight-month period.⁶⁰ The qualitative aspect is met if a distribution is made equally across all classes of shareholders. The aim of the distribution requirement is to prevent a FBI from capitalizing its dividend earnings and effectively deferring tax on such income.⁶¹ A FBI has withholding tax obligations, but the credit mechanism along with its 0% tax rate status makes it similar to a pass through entity.⁶² The outcome is that there are no tax at the FBI level and any tax costs are put on its participates (investors).

Foreign investment funds would be subject to a Dutch dividend WHT on their share of any distributions made by a FBI. This is the same case for a Dutch FBI, but mechanisms are in place to offset any Dutch WHT on their share of an FBI distribution against end domestic end investors' personal or corporate income tax.⁶³ So far, foreign end investors have not had this opportunity under the Dutch legislative framework.

The rationale behind the Dutch fiscal tax measure was to allow investment funds to effectively pass-through the underlying WHT to its participants.⁶⁴ Consequently, the participants would be taxed in the same way as if the participants were invested directly in the shares of the fund. Through this method the tax neutrality was achieved, which lead to the same tax burden for investors compared to a direct investment in the domestic case. However, in a cross-border situation the recipient of a non-resident investment fund would be subject to a higher tax rate due the final WHT compared to a Dutch investor. Thus, foreign investment funds claimed that denying such a refund would place them in a less favorable position compared to funds who have been granted the FBI status.⁶⁶

The Dutch Supreme Court assessed the comparability at the level of shareholders and held that by extending tax benefits to non-residents funds would indirectly

⁵⁹ The case number is 14/03956 and the decision was handed down in 10. July.2015.

⁶⁰ G. Hippert, The TFEU Eligibility of Non-Eu investment funds Subjected to Discriminatory Dividend Withholding (2016). EC Tax Review, p. 80

⁶¹ Supra, p 80.

⁶² Supra p 80.

⁶³ Supra, p 80.

⁶⁴ Supra, p 80.

⁶⁶ Supra, p 80.

benefit from the same tax benefits, namely a rebate for Dutch WHT. According to the court this would put investors investing through foreign investment funds in a better tax position than those non-residents funds who invested directly.⁶⁷

In parallel with the Netherlands decision, a number of taxpayers have challenged the Danish system, in which similar preliminary questions were asked to the CJEU.⁶⁸ The Supreme Court admitted that there is no full clarity how to apply the comparability test. Thus, the Dutch Court referred questions to the CJEU, in order to receive full clarity whether the judgement held by the Supreme Court was correct. Both, the Dutch FBI and Danish Fidelity Fund case shows how complex and difficult it can be to determine the questions of comparability and possible restrictions of withholding tax on dividend payment regards of investment funds. In order to understand whether the tax measure is discriminatory it is important to analyze the comparability in regards of investment funds. In order to receive clarification at this matter, following chapter will analyze how the comparability test should be held.

⁶⁷ G. Hippert, *The TFEU Eligibility of Non-Eu investment funds Subjected to Discriminatory Dividend Withholding* (2016). *EC Tax Review*, p. 80.

⁶⁸ Case C-480/16, *Fidelity Fund*.

3. Comparability Analysis

3.1 Comparable Situation

When a domestic law grants different treatment to foreign UCIT such provision is likely to hinder the protected freedoms. In that case it is then necessary, to verify whether different situations are objectively comparable. The comparability of a cross-border situation has to examine the aim and purpose pursued at issue by national provision.⁶⁹ As provided by the Danish national court the aim of the Danish tax provision is:

“(i) to prevent series of double taxation charges when an investment is made through a UCIT;

(ii) and, to ensure that dividends distributed by Danish companies do not elude Denmark’s power to impose taxes on the account of the exemption they enjoy at the level of residence UCIT and are taxed once, namely as regards those members.”⁷⁰

In regards of the aim of preventing double taxation, the Court has discussed the matter in several cases. In the case *Denkavit*, the court stipulated that, when the aim of tax legislation is to prevent or mitigate double taxation, resident and non-resident shareholders receiving those dividends are not necessary comparable situation.⁷² However, as soon MS imposes a charge to tax the income both of resident and non-resident become comparable.⁷³ The aim of the second provision of national legislation was to refer taxation rights of distributed dividends to the level of UCITS Members.⁷⁴ This aim was to achieved through application of Article 16 C fund status by providing exemption from WHT. Resident UCITS in Denmark are obliged to deduct the WHT, chargeable to its shareholders, from the minimum distribution it has made to them.⁷⁵ Non-resident UCITS cannot deduct withholding tax from the dividends its distributes. This is mainly because foreign UCITS is covered by Danish

⁶⁹ Opinion of AG Mengozzi, Case C-480/16, Fidelity Funds, p 31.

⁷⁰ Supra, p 32.

⁷² Case C-170/05, Denkavit, p 34.

⁷³ Supra, p 34.

⁷⁴ Opinion of AG Mengozzi, Case C-480/12, Fidelity Funds , p 32.

⁷⁵ Supra, 39.

taxation powers only in respect of dividends that it receives from the sources in Denmark.⁷⁶ Therefore, as the aim of the provision is to move the level of taxation from the investment vehicle to the shareholder, the question arises, when examining comparability of the situations, whether the tax situations of shareholders have to be taken into considerations.⁷⁷ If a MS decides to more favorable tax treatment to resident companies, the benefit should be also applicable for investment funds who are in comparable situations.

3.1.1 Whether the tax situation of shareholder has to be taken into account when assessing the comparability of investment funds?

In early 2012, the French Administrative Court of Montreuil referred several cases to the CJEU, dealing also with the question, whether the tax situation of shareholder has to be taken into account.⁷⁸ The consolidated case, known as *Santander* case, together with other similar case laws in Aberdeen⁷⁹ and Emerging Markets⁸⁰, have been the main subject of the debate by interested parties as well as by the AG General who stated its opinion on case Fidelity Fund.⁸¹ The parties questioned whether the conclusion of the Fidelity Fund case should be drawn from those judgments, focusing on the Santander case. The Santander case concerned the French domestic tax provision, under which dividend distributed by resident companies to non-resident UCITS, were taxed at the rate of 25% WHT, when such dividends were exempt from tax when paid to resident UCITS.⁸² The aim of the tax legislation was similar to the facts represented in Denmark Fidelity Fund case. The purpose of the tax legislation was not to forego all taxation of dividends distributed by the company resident in Denmark, but to refer their taxation rights to the level of UCIT members. The French government argued that collective investment funds acting on behalf of their shareholders.⁸³ As such, the UCITS involvement is neutral, the dividends which they receive are not taxed.⁸⁴ Taking into account their tax neutral nature, the situation of

⁷⁶ Opinion of AG Mengozzi, Case C-480/12, Fidelity Funds, p 32.

⁷⁷ Opinion of AG Mengozzi, Case C-480/12, Fidelity Funds.

⁷⁸ Case C-338/11, Santander.

⁷⁹ Case C-303/07, Aberdeen.

⁸⁰ Case C-480/16, Emerging Markets.

⁸¹ Opinion of AG Mengozzi, Case C-480/16, Fidelity Funds.

⁸² Case C-338/11, Santander, p 16.

⁸³ Supra, p 27.

⁸⁴ Supra, p 25.

shareholders has to be also taken into consideration. The ECJ rejected those arguments, and instead confirmed that as the French legislation only establish distinguishing criteria based on UCITS residence, in that case it only concerns non-resident UCITS to WHT on dividends which they receive.⁸⁵ Therefore, the French tax legislation, did not require a link between the earning of the dividends by the UCITS and the taxation of those dividends in the hands of the UCITS shareholders.⁸⁶

Until now, in the case *Aberdeen*, *Santander* and *Emerging market*, the only relevant distinguishing criteria in the domestic legislation was the place of residence of the UCITS. Meaning that the situation of the investor was irrelevant determining whether the legislation was discriminatory or not. In other words, only the position of UCIT was taken into account. It is also important to keep in mind, that the recent case law analysis comparability of investment funds which are either subject to UCIT Directive or classified as corporate fund under the domestic law of the Member States. Until now there are no ECJ rulings concerning the transparent investment funds for tax purposes. Some of the Experts have argued that in cases where the investment fund is considered as a transparent entity for tax purposes, it makes sense to look at the unit-holders of the investment funds when carrying out comparison.⁸⁷ Often the legal form of the fund is chosen in connection with principle of tax neutrality or/and tax avoidance schemes. Furthermore, the taxation of investment income derived by an investment fund is just a cost that is directly incurred by its members.⁸⁸

Different result was ruled by the Netherland Supreme Court in case *Koln-Aktiefonds Deka*. According to the court the Dutch tax legislation, specifically established a link between the tax treatment for fund and its investor, through distribution requirement. This view is also accordance with other ECJ rulings held before *Santander* case. In *Orange European Smallcap* the Court came to the conclusion, that the perspective of the investor had to be taken into account because the domestic legislation demanded it.⁸⁹ The same approach is explained

⁸⁵ *Supra*, p 29.

⁸⁶ Geoff Hippert, *The TFEU Eligibility of Non-EU Investment Funds Subjected to Discriminatory Dividend Withholding Taxes*, p 79.

⁸⁷ *Supra*, p 47.

⁸⁸ *Supra*, p 80.

⁸⁹ Case C- 194/06, *Orange European SmallCap Fund*.

by the AG *Mengozzi*, in the Danish pending case the *Fidelity Funds*.⁹⁰ The AG held that: “*in so far as those rules are based on the place of residence of the UCITS concerned, the situation must be compared only at the level of those undertakings*”.⁹¹ However, as there is also a link established by the Danish legislation between the grant of the exemption to a resident investment fund and the tax situation of their members, the situation of the member should also be taken into account.⁹² Thus, the AG found that, in contrast to the situation in the judgement of *Santander*, there was a link between the shareholder and tax legislation.

⁹⁰ AG Opinion, Case C-480/16, *Fidelity Fund*.

⁹¹ *Supra*, p 40.

⁹² *Supra*, p 50.

3.1.2 Comparability assessment at investment fund level

The ECJ has repeatedly stipulated that once Member State imposes a dividend WHT on both, resident and non-resident shareholders, it places both of them into the same position. Since the ruling held in the case Aberdeen, the same principle was extended to the investment funds. It settles case law that if two categories of taxpayers are in a comparable situation, only such a treatment could be discriminatory. The question should then be, what is an objective comparable situation when investment funds are involved in a scenario like the one in analysis. The legal treatment given to investment funds varies according to the characteristics of the fund. As discussed below, each MS have the competence to regulate investment funds as they see it convenient. As an example, some countries recognize both contractual and corporate funds and given them separate tax treatment and further requirements.⁹³ Another countries make distinguish between close-end and open-end investment funds. An final one the distinguish is made between accumulative and distributive fund, whereas the special treatment is given if the fund distributes within the certain period of time and such treatment consist of reimbursement the amount withheld to the fund.⁹⁴ Different legal approaches and characteristics of investment funds makes the comparability assessment difficult.

According to the Prof. Antonio Callisto Pato, when performing the comparability test it is necessary to determine if the two categories of taxpayers are in a comparable situation⁹⁵. The Prof. believes that the comparison analysis must be split in two different cumulative dimensions: A structural comparison and a taxation comparison to analyze if structurally comparable funds are in the same tax situation.⁹⁶ Following this approach, the chapter is divided between structural comparison and the comparable tax situation.

⁹³ Calisto, A, Cross-border direct tax issues of investment funds from the perspective of European law.

⁹⁴ Supra.

⁹⁵ Supra.

⁹⁶ Supra.

3.1.3 Structural Comparison

As previously discussed, UCIT funds are regulated by the UCITS Directive, the aim of which is to coordinate laws governing the collective investment undertakings with a view to approximate the conditions of a community level.⁹⁷ Following the ECJ arguments in case SPF Finance, recitals two to three of Directive 85/611 determines that: *“in order to ensure that UCITS units are marketed freely within the European Union, that this directive sought to harmonize national laws governing UCITS, in order, first to approximate, within the European Union the conditions of competition between those undertakings, and, secondly to ensure more effective and more uniform protection for unit-holders.”*⁹⁸ Considering the arguments presented by NN (L) SICAV and Fidelity Fund, UCITS status governed by the Directive 85/611 is sufficient for finding that non-residents are objectively comparable with residents. Furthermore, parties claimed that if the distribution requirement were to be imposed on all non-resident UCITS, the harmonization carried out by the Directive 85/11 would be meaningless.⁹⁹ The aim of the national legislation, in the main proceeding, is preventing a series of charges of tax or economic double taxation and/or achieving tax neutrality. According to the recital 36 of the Directive, UCITS Directive should not affect national rules on taxation, including arrangements that may be imposed by Member States to ensure compliance with those rules in their territory.¹⁰⁰ From this perspective, one may argue that, MS have the right to regulate taxation of investment funds as they see it convenient. Furthermore, the Directive allows MS to apply stricter measures, provided that they are generally applied and do not conflict with the provision of the Directive. However, article 44 (3) of the Directive requires, that provisions applicable to the UCITS, which do not fall within the subject of UCIT Directive has to

⁹⁷ Directive 2014/91/EU of the European Parliament and Council amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions for Collective Investment in Transferable Securities as regards depositary functions, remuneration policies and sanctions. 23 July 2014.

⁹⁸ Case C- 48/15, SPF Finances, p 31.

⁹⁹ AG Opinion, Case C-480/16, Fidelity Fund, p 10.

¹⁰⁰ Supra, p 10.

be applied in a non-discriminatory way.¹⁰¹ It is settled case law that discrimination arises through application of different rules (cross-border situation).¹⁰² In other words, source state must treat all non-residents in an way that is comparable to its residents, to the extent to which the foreign investment fund falls within its tax jurisdiction. Thus, one could conclude that when a state imposes a measure, the measure cannot go further than necessary, as the outcome cannot be different to the objective of the Directive and the principles of EU law. Stricter measure may be adopted if it applies equally to resident and non- resident UCITS. In other words, discrimination concerning the direct tax treatment is against the scope of Directive and it must be interpreted accordance with the protected freedoms. From this perspective, contrary to the opinion of the AG in case Fidelity Fund, one could argue that that investment funds transposed by the UCITS Directive could be considered as structurally comparable with each other.

The judgement of Emerging Markets concerns comparability test of investment funds residence in third countries. As mentioned in second chapter of the thesis, the scope of the provision of free movement of capital is wider comparing to other freedoms. It is only freedom applicable to the companies established outside European Union or European Union Economic Area. The judgement of Emerging Markets concerns comparability test of investment funds residence in third countries. In this case the ECJ questioned whether an US investment fund could qualify for Polish tax exemption on dividends earned in Poland.¹⁰³ Under the Polish law WHT on dividend distributions for collective investment funds registered in EU were tax exempted. Poland argued that UCIT Directive applies only to investment funds, with registered offices in the EU. The court analysed whether the UCIT Directive could be a term of comparability for both, resident and non-resident investment funds.¹⁰⁴ The court stipulated that UCIT and non-UCIT (non-transparent) investment funds are comparable:

¹⁰¹ Case C-48/15, NN (L) International SA vs SPF Finance, p 32.

¹⁰² Supra, p 33.

¹⁰³ Case C-190/12 Emerging Markets of DFA Investment Trust Company.

¹⁰⁴ Supra, p 51.

“Since the UCITS Directive does not apply to investment funds established in non- Member State countries, because they are outside the scope of European Union law, a requirement that such investment funds be regulated in the same way as resident investment funds would deprive the principle of free movement of capital of any practical effect.”¹⁰⁵

Court did not accept that UCIT directive could be used as a term of comparability. Instead it explained that if both resident and foreign investment funds run the risk of economic double taxation on their locally sourced dividend income, and if the host state provides tax relief only for the resident, then both funds are comparable situation.¹⁰⁷ According to this judgement, one could argue that UCIT Directive is not a term of comparability.

3.1.2 Non-UCIT

Where a foreign investment fund does not qualify as UCIT fund, the comparability analyze becomes more complicated, as there are no harmonization measure in the EU. Thus, based on the above discussed, the comparability of non-UCIT funds should be based on objective criteria and substantive approach. On the other words, the classification of the fund (objectives of the fund and the administrative policies). This view is also supported both by the legal literature as well as previous case law.

¹⁰⁵ Supra, p 67.

¹⁰⁷ Case C-190/12 Emerging Markets of DFA Investment Trust Company.

4. Restriction of Free Movement of Capital

Having argued in the previous chapter that the comparability should be analysed through two different cumulative dimensions: a structural comparison and comparable tax situation. This part of the thesis, focuses on the second dimension. According to the ECJ, higher tax rate for foreign investment funds or investors (compared to residence investor or fund) is a restriction on the free movement of capital, which is protected by article 63 TFEU. Higher tax burden can take different forms and occur in different ways. In connection with cross-border indirect investments, the situation where the foreign investor is subject to final WHT, while residence investor could set-off WHT from its individual or corporate income

tax, is one of the example. These tax schemes should be deemed to mitigate double taxation and ensure tax neutrality (domestically). This issue is especially relevant in the comparability analysis made at the level of shareholders. For this purpose, present chapter provides a comprehensive overview of the ECJ most important case law at this matter. Both Denmark and Netherland have questioned whether the domestic tax measure which results in a final levy on WHT on dividends distributed to non-resident investors, while a resident investor could set-off WHT from his corporate or income tax, could be considered restriction in the light of free movement of capital¹⁰⁸. On September 17, 2015 the ECJ released ruling on case *Miljoen and others*.¹⁰⁹ In *Miljoen* case residents could offset the WHT liability- by deducting it from their income tax, or it is reimbursed to the extent it exceeds the income tax. In this case the question was whether the set-off should be taken into account when determining the tax burden for the shareholder. The ECJ stipulated that as the different treatment is not triggered through different tax collection methods, but might only occur due

¹⁰⁸ AG Opinion, Case C-480/16, Fidelity Fund.

¹⁰⁹ Joined Cases C-10/14, C-14/14 and C-14/17, *Miljoen and others*.

to different tax amounts, the set of must be taken into account when calculating tax burden.¹¹⁰ According to this judgement, both tax levied-withholding tax - and the taxation at source must be considered a part of the assessment. This reasoning is also accordance with other case law. For example, in the case *FII Group Litigation*, the court stated that using two types of taxing techniques did not constitute a breach of EU law, as long as the foreign taxpayer was not treat worse than the domestic one.¹¹¹

In the *Miljoen* case, however, the parties used different tax methods as an argument to reject comparability, by referring to the “Truck Center” .¹¹² The CJEU rejected this argument. Instead it stipulated that different taxing methods for residence and non-residence are allowed in certain cases.⁸¹ This argument can be triggered from the Paragraph 48 of the *Truck Center* case:

“Moreover, in addition to the fact that it relates to situations which are not objectively comparable, the difference in treatment resulting from the tax legislation at issue in the main proceedings does not necessarily procure an advantage for resident recipient companies, because, as was pointed out by the Belgian Government at the hearing, those companies are obliged to make advance payments of corporation tax and, secondly, the amount of WHT deducted from the interest paid to a non-resident company is significantly lower than the corporation tax charged on the income of resident companies, which receive interest..

In those circumstances, where differences in treatment does not constitute a restriction of the freedom of establishment within the terms of Article 52 of the Treaty. Hence, a restriction of the freedom of establishment has to occur for there to be a discrimination.”¹¹³

Therefore, one can argue that WHT levied on dividends distributed to non-resident shareholder, could be compared to the income of resident taxpayers. The AG Jaaskinen argued that it is not sufficient to compare the statutory

¹¹⁰ K. Spindler- Silmader, Dividend withholding taxes after *Miljoen*, X and *Societe Generale*, p 2.

¹¹¹ Case C-446/04, *FII Group Litigation*.

¹¹² K. Spindler- Silmader, Dividend withholding taxes after *Miljoen*, X and *Societe Generale*, p 3.

¹¹³ Case C-282/07 *Truck Center*, p 48.

dividend tax rate 15% - at the level of shareholders and non-shareholders.

¹¹⁴This is because the provision does not take account that it is the final WHT for residents, and therefore the effective tax rate for non-residents would be higher. CJEU followed the AG opinion and decided that non-residence was subject to a higher tax burden. Based on this analysis and the similar facts of the Koln-Aktiefonds Deka case, it could be argued that the Dutch tax regime is incompatible with fundamental freedoms. Because the tax burden for non-resident shareholder will be higher (final levy). Whereas resident shareholders have possibility to off-set the tax from its income or corporate taxation.

¹¹⁴ K. Spindler- Silmader, Dividend withholding taxes after Miljoen, X and Societe Generale, p 3.

Conclusion

The purpose of the thesis was to evaluate whether the WHT tax on distributed dividends to foreign investment funds is discriminatory. The recent ECJ cases highlight some of the trends and precedents set out: In the cases *Aberdeen* and *Santander*, the court extended the principle that a non-resident company would be comparable to a resident company, if the source state imposes a form of dividend taxation on dividends earned by both the resident and non-resident investment company. When a source state provides any type of tax relief for the resident fund, it should extend it to the non-resident fund.

Secondly, the comparability has to be subject to substantive analysis together with the aim of the national tax provision. Moreover, the legal analysis shows that the foreign taxpayer cannot be subject to a higher tax burden compared to the resident taxpayer in a similar situation. The comparison between the tax burdens of the resident and non-resident with respect to the dividend income has to be based on the total tax burden suffered by the resident and non-resident taxpayer. This was a result from the recent rulings held in the case *Miljoen*. The outcome questions the Dutch Supreme Court decision held regarding the FBI regime. Especially as the AG presented opinion in the case *Fidelity Funds*, to the *Miljoen* case. It seems that if the Dutch court would compare the resident Dutch participant in the FBI with a non-resident investor of a Luxembourg SICAV, the FBI could be ruled to be discriminatory, because of its higher effective tax rate.

It is also important to recognize, that the CJEU case law addresses the issues only for non-transparent companies, which are considered as taxable entities. Until now, no case law with regards to the conduit companies have been discussed. It is therefore, clear that there is a gap between the case law in the sense that it does not address how pass-through funds should be treated. Due to the ongoing and many contemporary cases, this would be of great interest to other scholars in the coming years.

Based on the existing case law, guidance is only offered in relation to the fundamental freedoms and the illustrated trends the thesis has analyzed. It is the author's opinion that these issues should be considered in relation to transparent investment funds.

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