

Tax News Bulletin

3 June 2016

ECJ rules that Sweden's tax treatment of non-resident pension funds is not a prohibited restriction of the free movement of capital

On 2 June 2016, the ECJ ruled that Sweden's different tax treatment of non-resident pension funds as compared to domestic pension funds is not a prohibited restriction of the movement of capital (art 63 of the Treaty on the Functioning of the EU, "TFEU", commonly known as the EU Treaty). In doing so, the ECJ follows the conclusion of AG Szpunar of 10 September 2015.

Legal background

Article 63 TFEU prohibits all restrictions on the movement of capital between Member States, and between Member States and a third countries. A restriction can be justified only if resident and non-resident taxpayers are not in an objectively comparable situation, or in case of overriding reasons in the public interest.

In the context of tax on dividends, a provision of domestic (tax) law restricts the free movement of capital when a difference in treatment of the taxation of dividends paid to pension funds, dependent on their status as residents or not, leads to less favorable treatment of non-resident pension funds compared to resident pension funds.

Relevant facts

Under Swedish tax law, dividends paid to resident pension funds are subject to an income tax over their net assets (total assets minus total debts) multiplied by the average return on government bonds in the preceding year, at a flat rate of 15%. Resident pension funds are therefore taxed annually irrespective of whether and how much dividend income they have received ("standard yield taxation"). Dividends paid to non-resident pension funds, on the other hand, are subject to a tax withheld at the source over the gross amount of the dividends, at a flat rate of 30%. Resident pension funds are therefore taxed only when they receive dividend income, and on the actual dividend income. Under the applicable Netherlands – Sweden double tax treaty, the rate is reduced from 30% to 15%.

Dutch pension fund "PMT" requested a full refund of the 15% Swedish tax withheld from gross dividend income which PMT had received from its Swedish portfolio shares in the period 2002 – 2006, claiming that it was treated less favorably than Swedish pension funds. After PMT appealed the Swedish tax

authorities' decision to deny the refund request, the Swedish tax court referred to the ECJ for an answer to the following prejudicial question:

'Does Article 63 TFEU constitute an obstacle to national legislation under which dividends from a resident company are taxed at source if the shareholder is resident in another Member State, while such dividends, if paid to a resident shareholder, are subject to a tax calculated as a definitive lump sum and on a notional yield, which, over time, is intended to correspond to the normal taxation of all yields on capital?'

ECJ's key considerations and decision

In accordance with its long standing case law, the ECJ set out the relevant framework and narrows down the prejudicial question by considering that:

- ✓ The difference in treatment regarding the Swedish taxation of dividends paid to resident pension funds and the taxation of similar dividends paid to non-resident pension funds, is capable of resulting in the dividends paid to those latter funds bearing a heavier tax burden in comparison to that borne by resident pension funds. Such a difference in treatment is liable to deter such non-resident pension funds from making investments in that Member State and, consequently, amounts to a restriction of the free movement of capital prohibited, in principle, by Article 63 TFEU.
- ✓ Such restriction may be justified if resident and non-resident pension funds are not in objectively comparable situations
- ✓ Whether resident and non-resident pension funds are in objectively comparable situations must be examined having regard to the aim pursued by the national provisions at issue

After having narrowed down the prejudicial question, the ECJ arrives at the key question: does the aim pursued by the national provisions at issue justify the restriction. In this regard, the ECJ considers that: The Swedish national legislation on the taxation of resident pension funds means to introduce neutral taxation independent of the economic climate surrounding various kinds of assets and all of the kinds of pension products concerned. And in order to achieve this specific aim, all the assets of a resident pension fund are subject to yearly lump sum taxation, reflecting the yield of those assets, irrespective of the receipt of income generated by those assets, in particular the receipt of dividends (standard yield taxation).

According to the ECJ, the Netherlands – Sweden tax treaty does not allow Sweden to tax non-resident pension funds like it taxes resident pension funds, i.e. on a standard yield basis, because this treaty only allows taxation of dividends *actually paid*. Therefore, as a result of this treaty, the specific aim pursued by the national legislation at issue – described above - can not be achieved in respect of non-resident pension funds. Consequently, in the view of the ECJ, resident pension funds and non-resident pension funds are not in an objectively comparable situation, and non-resident pension funds may be taxed differently.

ECJ's other considerations

In addition to answering the key question, the ECJ clarified that the question whether non-resident pension funds are treated less favorable must be assessed for each tax year individually, not over the course of several years. In other words, the fact that the tax treatment of non-resident pension funds may be more beneficial than the tax treatment of resident pension funds in some of the years, still can not justify a less favorable treatment in other years.

Furthermore, the ECJ considered that, in relation to professional expenses directly linked to an activity that has generated taxable income in a Member State, residents and non-residents of that State are in a comparable situation. The ECJ therefore referred the case back to the Swedish court to determine whether the taxation method applied to resident pension funds, by means of the calculation of the tax base of those funds and, in particular, the inclusion of their liabilities in the calculation of the capital base, allows for the taking into account of any professional expenses directly connected to the receipt of dividends. If that were the case, it should also be admissible to take into consideration such expenses in respect of non-resident pension funds.

Our view on the ECJ's decision

It appears that this decision is the first decision in which the ECJ clarifies how the specific aim pursued by the national legislation issue may make the situation of non-resident pension funds objectively incomparable to that of resident pension funds. It also appears to us that, because of the key role of the very specific aim in the Swedish taxation of resident pension funds, the scope of applicability of this decision should be limited to Swedish sourced dividends (but irrespective of where the recipient pension fund is resident). Member states that do not have a specific aim in their national legislation which would be impossible to achieve with non-resident pension funds, would likely not be able to successfully invoke this decision to justify their different taxation of non-resident pension funds.

The decision from the ECJ can be accessed by clicking on the following link: <http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:62014CJ0252&rid=5>

For more information the proposed amendments to the innovation box, please contact Jeroen van der Wal (jeroen.vanderwal@ohp.nl).