Relief at Source and Refund: Status Quo

Practical issues

25 April 2024

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LEGAL BASIS

What could be the legal basis for a WHT reclaim procedure?

- Domestic Law
- Double tax treaty
- EU Law

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LEGAL BASIS

What could be the legal basis for a WHT reclaim procedure?

Domestic Law – example Sweden

When income taxation of investment funds was eliminated at fund level in 2012 and replaced by imputed income at the level of the fund's shareholders, an exemption of WHT was implemented on dividend distributions for foreign investment funds. The exemption now covers foreign special funds, among others. The rule that says that foreign special funds should be exempt from withholding tax on dividends is included in article 4, ninth paragraph in the Act on Withholding Tax on Dividends. The first and second paragraph of that article provide a list of the entities that are subject to withholding tax on dividends. A foreign fund that is not a legal person is not within the scope of that list.

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LEGAL BASIS

What could be the legal basis for a WHT reclaim procedure?

Double tax treaty

A tax treaty is a bilateral (two-party) agreement concluded by two countries to resolve issues involving double taxation of passive and active income of each of their respective residents. When an individual or business invests in a foreign country, the issue of which country should tax the investor's earnings may arise.

Relatively easier compared to domestic or European law-based claims. Those types of claims follow a standard procedure, usually a limited number of documents are required.

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LEGAL BASIS

What could be the legal basis for a WHT reclaim procedure?

The free movement of capital is one of the four fundamental freedoms of the EU single market, the only one applicable to third countries, since the Maastricht Treaty (1994), restrictions on capital movements and payments were removed, for both between Member States and with third countries.

The 'four freedoms' of the European Union are the freedom of movement of goods, people, services and capital over borders. These key principles lie at the heart of the EU and underpin the single market, originally known as the common market.

LEGAL BASIS

What could be the legal basis for a WHT reclaim procedure?

The principle that has been developed in ECJ jurisprudence is that a non-resident fund should be entitled to the same treatment as a resident fund if it can prove that it is comparable to a resident fund.

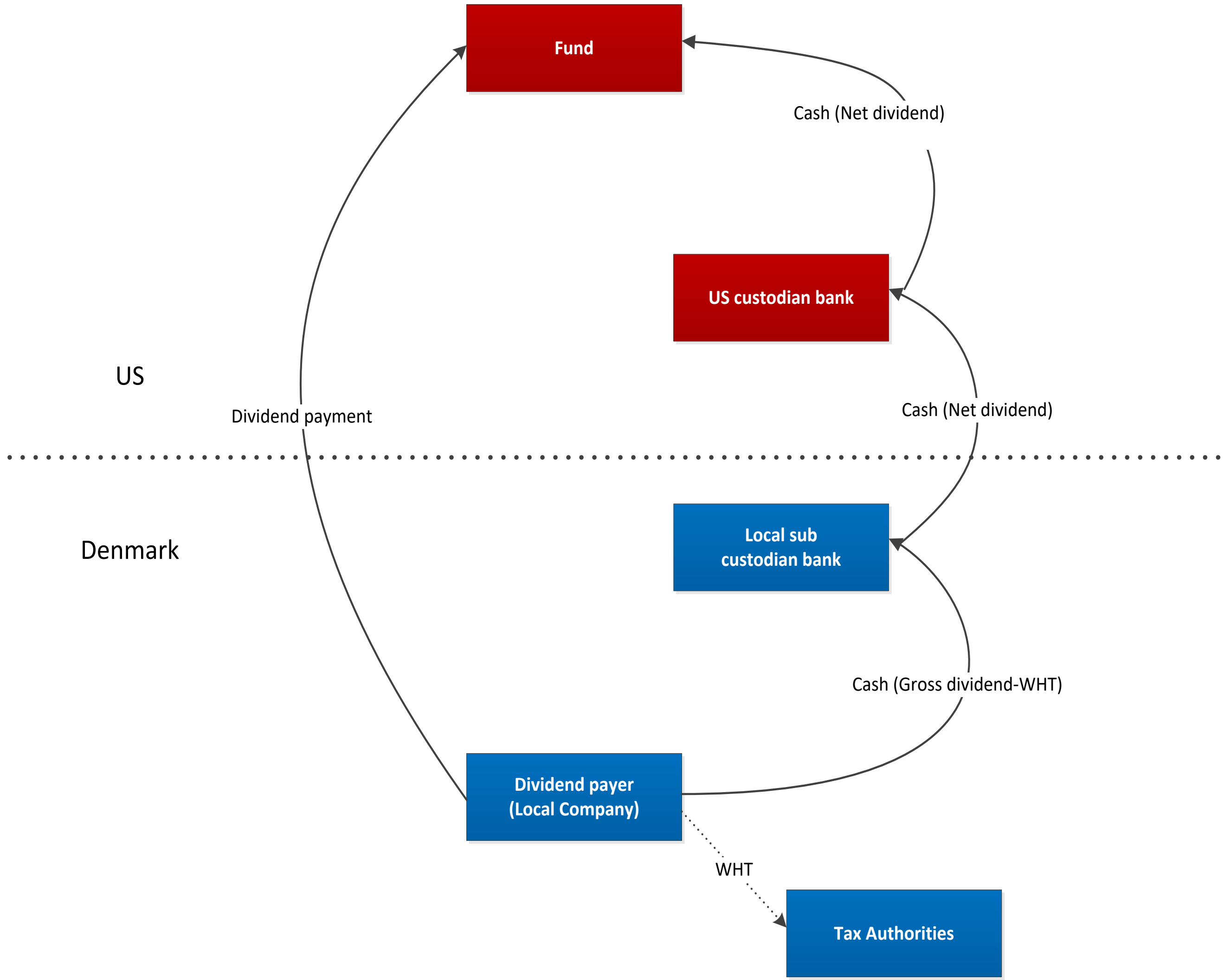
This means that in order to be able to reclaim the withholding tax paid in excess, a fund must also prove that it is comparable to a resident fund that has not been subject to withholding tax (or which has been levied at a more favourable rate).

The measure that has been applied is the UCITS IV Directive, based on the argument that an EU Member State cannot differentiate between a UCITS on the basis of its residence.

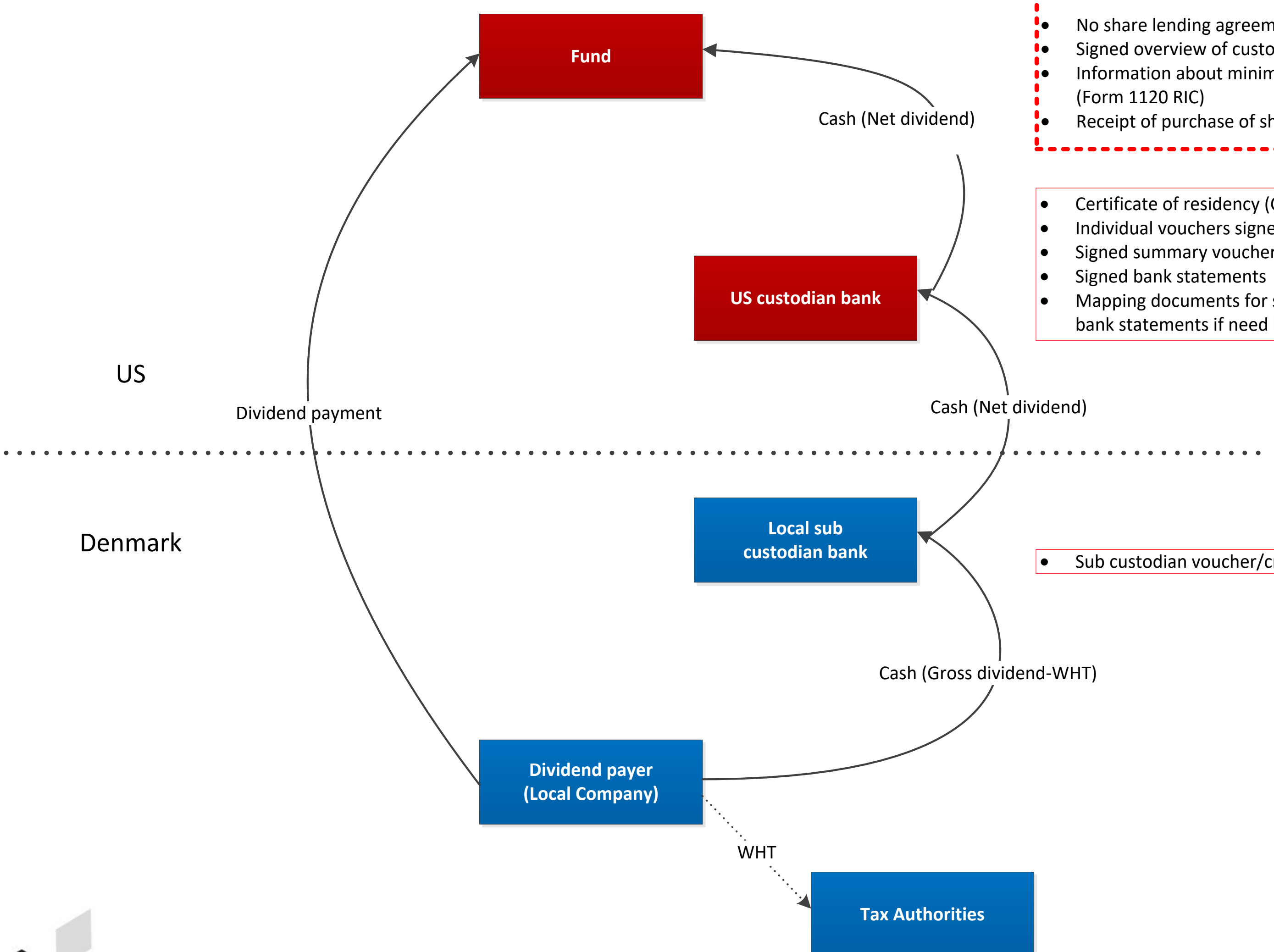
In case of non-EU resident entities there are no such guidelines that can be used to determine the comparability of the funds. However, the characteristics and requirements set out in the UCITS IV Directive are to be taken as a basis for the comparability analysis.

It should be noted that the ECJ has held in Santander that the level at which the review of the comparability of the situations is to be carried out is to be done at the level of the investment vehicle itself, rather than at the level of the unit holders (as this is the approach the local law uses).

Importance of proof and accuracy



Importance of proof and accuracy



- No share lending agreement declaration
- Signed overview of custody account
- Information about minimum distribution requirement (Form 1120 RIC)
- Receipt of purchase of shares

- Certificate of residency (CoR)
- Individual vouchers signed
- Signed summary vouchers + excel income summary
- Signed bank statements
- Mapping documents for sub custodian vouchers/ bank statements if need be

- Sub custodian voucher/credit advice signed

Cum-Ex trading

Cum – Ex trading

The participants in the network would lend each other shares in large companies, so that to tax authorities there would appear to be two owners of the shares, when there was only one. The bank that was used in stock trading would then issue a "confirmation" to the investor that tax on the dividend payment had been paid, without it being done. This practice was outlawed in 2012.

The name "cum-ex" is derived from Latin, meaning "with without", and refers to the disappearing nature of the fraudulent dividend payments.

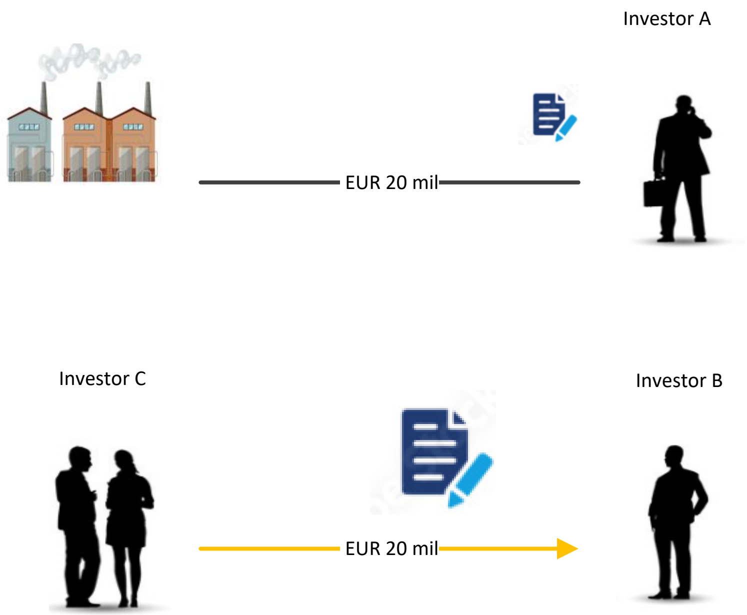
In cum-ex trades, shares with and without dividend rights were quickly traded between various market participants just before the payout date for the dividend, allowing traders to reclaim double the taxes.

Financial institutions in essence exploited a legal loophole which allowed two parties to simultaneously claim ownership of the same shares, therefore allowing both to claim tax rebates to which they were not entitled. In Germany, this loophole caused government loses for over 10 billion.

Authorities have since deemed the reclaims illegitimate, but at the time of the trades, this was less black and white, and a vast network of traders, analysts and lawyers were thought to be involved in the practice throughout the continent.

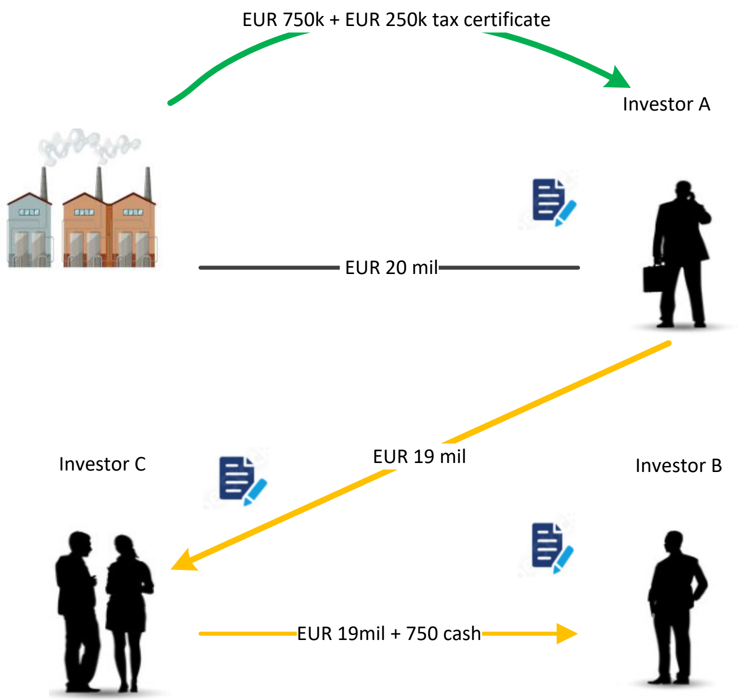
Although this practice was “invented” in Germany, it quickly spread to other countries as well. One of the most prominent cases is the so-called “Danish Fraud case”, which led to 1billion EUR loses for Denmark. Due to this case, on 6 August 2015, the Danish tax authorities have suspended all payments on claims for the repayment of Danish dividend withholding tax based on a suspicion that a number of reclaims were fraudulent.

Cum-Ex trading



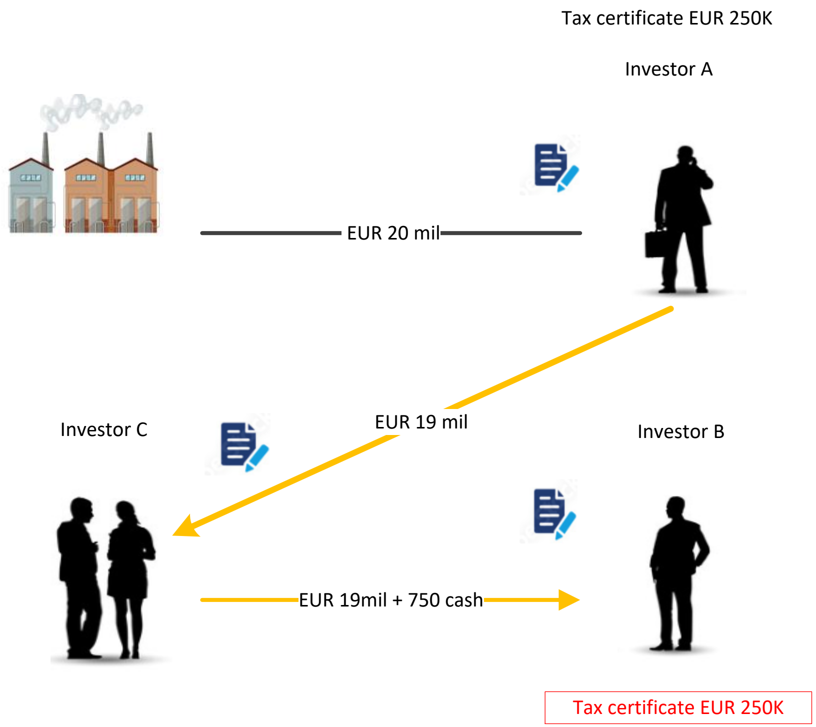
- Investor A owns shares in a German company valued at EUR 20mil.
- Investor C performs a short selling and sells shares worth EUR 20mil to investor B.

Cum-Ex trading



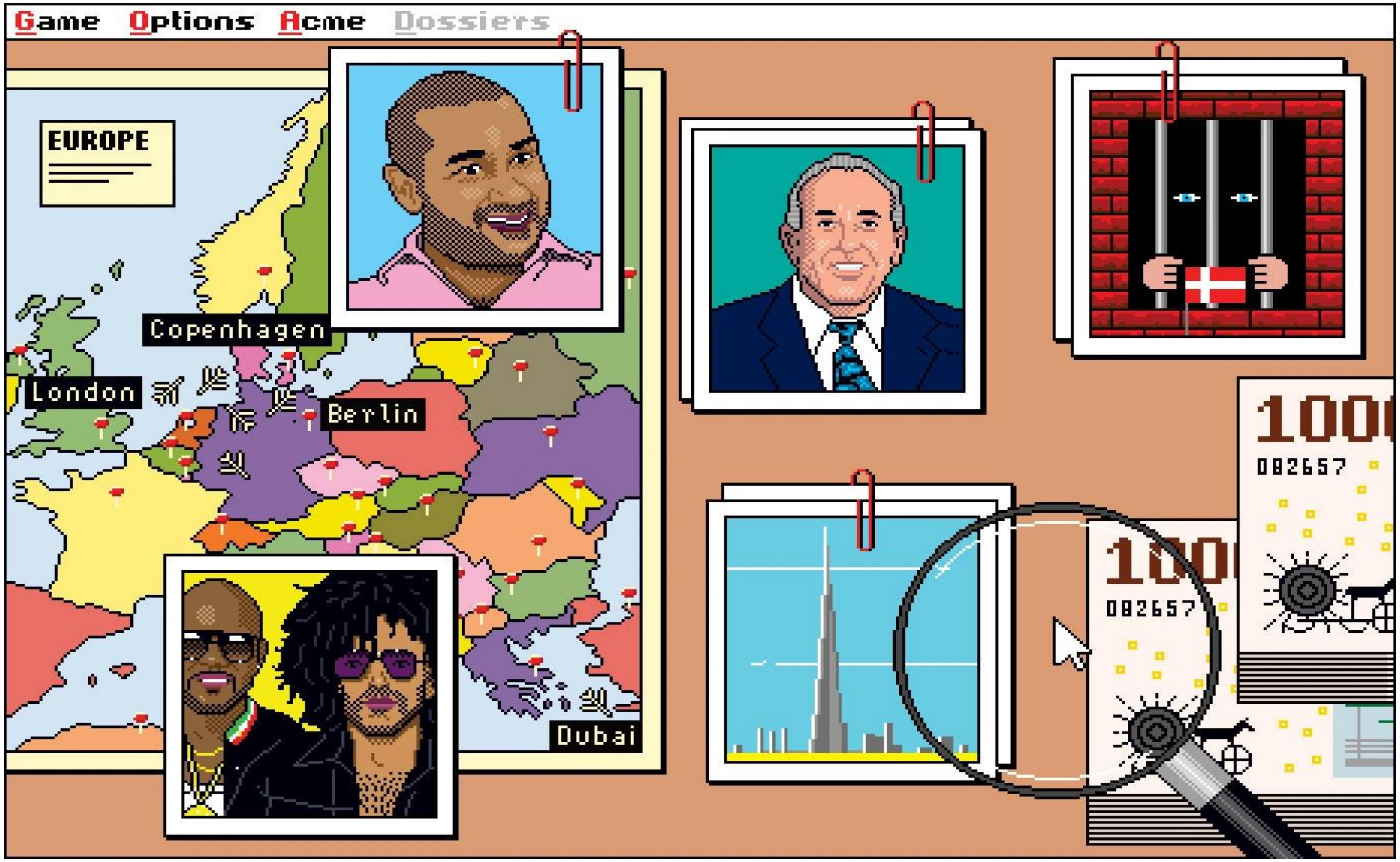
- The German company pays out dividend to investor A (EUR 750k) and he receives a tax certificate for EUR 250k. The shares are now worth EUR 19mil (EUR 20mil – EUR 1mil gross dividend).
- Investor A sells the shares for EUR 19mil to investor C, who delivers them to investor B and pays him additional amount of EUR 750k.

Cum-Ex trading



- Both investors A and B received tax certificates for EUR 250k.

Danish Fraud Case



Comparability

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- In case of non-EU resident entities there are no such guidelines that can be used to determine the comparability of the funds. However, the characteristics and requirements set out in the UCITS IV Directive are to be taken as a basis for the comparability analysis.

- It should be noted that the ECJ has held in Santander that the level at which the review of the comparability of the situations is to be carried out is to be done at the level of the investment vehicle itself, rather than at the level of the unit holders (as domestic law uses this approach as well).

Comparability

Comparability and compliance of the requesting entity with the requirements of Directive 2009/65/EC of the European Parliament and of the Council, of 13 July 2009 ("UCITS Directive")

1. That the nonresident taxpayer has the sole object of collective investment in transferable securities or in other liquid financial assets and it operates on the principle of risk-spreading.
2. That the taxpayer documents that the units are, at the request of holders, repurchased or redeemed out of the undertakings' assets.
3. That the taxpayer does not obtain capital for its operations other than through the sale of its units.
4. That it proves that the assets of the undertaking are entrusted to a depositary for safe-keeping and which fulfills the following functions:
   - It performs the sale, issue, repurchase or redemption of the units of the undertaking;
   - It ensures that the value of the units of the undertaking is properly calculated according to stock exchange values;
   - It appropriately safeguards all the financial instruments, values and other assets owned by the undertaking and, moreover, it verifies their ownership;
   - It proves that the depositary of the undertaking's assets will not reuse them, either itself or a third party, unless instructed to do so by the undertaking or by the representative thereof.
5. In the case of a company, it proves that it may only manage assets of its own portfolio and that it may not, under any circumstances, receive any mandate to manage assets on behalf of third parties.
6. It proves that the undertaking may not acquire either precious metals or certificates representing them.
7. It proves that the undertaking may not invest more than:
   - 5% of its assets in transferable securities or money market instruments issued by the same body, or
   - 20% of its assets in deposits in the same body.
8. And that the counterparty risk of the undertaking in an OTC derivative transaction shall not exceed one of the following percentages:
   - 10% of its assets when the counterparty is a credit institution;
   - 5% of its assets in all other cases.

Comparability

Cont'd

9. It proves that both the company and the fund publish, for purposes of transparency of unit-holders and investors:

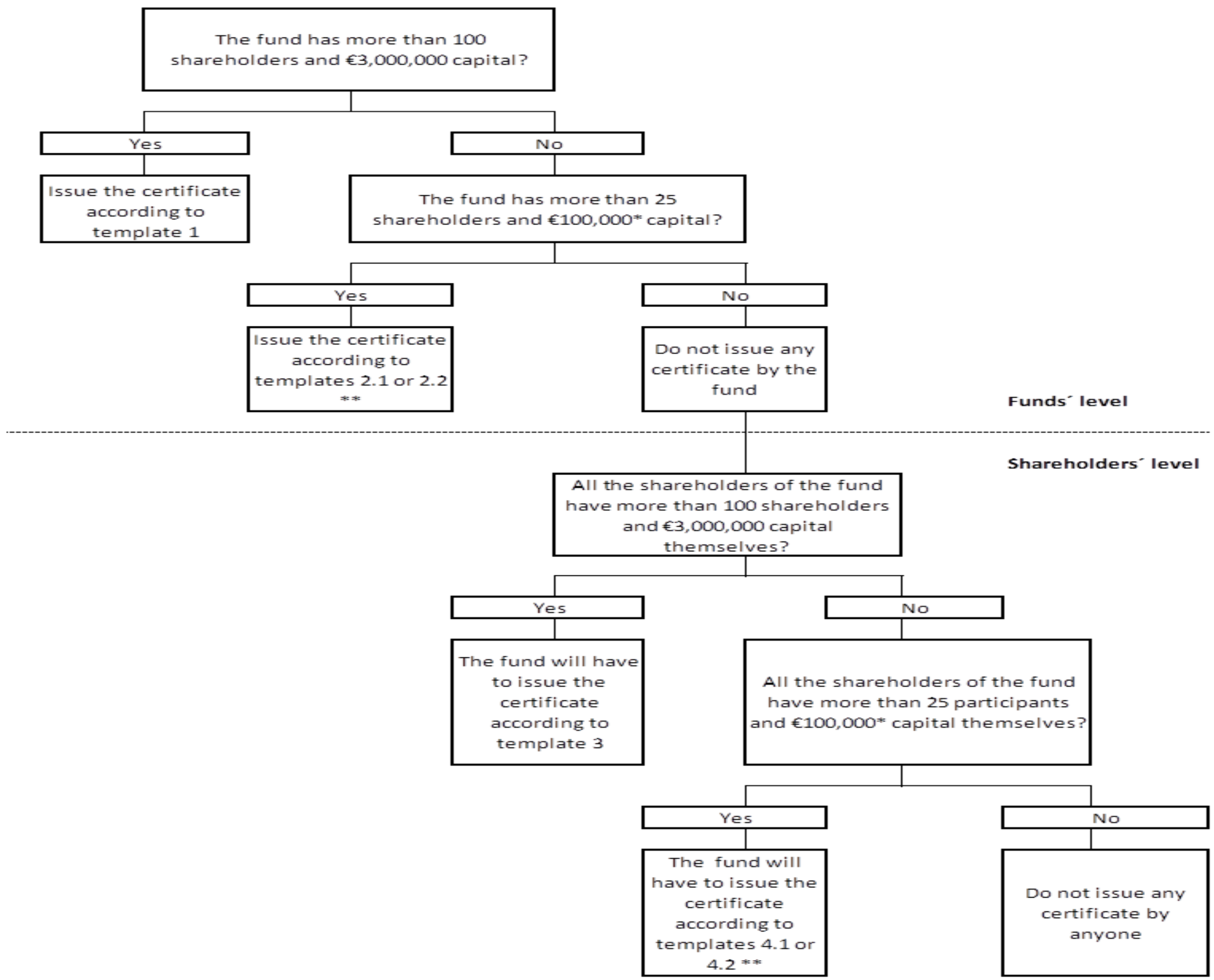
   - A prospectus (which shall contain the necessary information for investors to be able to make an informed judgment);
   - An annual report for each financial year, and
   - A half-yearly report covering the first six months of the financial year.

10. It is proven that the undertaking may not borrow any funds, nor the management company or depositary when acting on behalf of a fund, unless the loan is temporary and represents:

    - in the case of investment companies, up to a maximum of 10% of their assets, or
    - in the case of a common fund, no more than 10% of the value of the fund, or
    - it is to enable the acquisition of immovable property essential for the direct pursuit of its business and represents, in the case of an investment company, no more than 10% of its assets.

Comparability Spanish Case

Spanish Investment funds specific requirement



* €50,000 for years prior to FY2015
** Depending on the capital threshold applicable

Comparability Dutch Case

The requirements laid out in the FBI ("Fiscal Investment Institution") regime are as follows:

- Withholding tax obligation;
- Legal form requirement;
- Purpose test;
- Financing limitations;
- Re-distribution requirement;
- Shareholders requirements;
- Directors and commissioners requirement;
- Equal profit distribution requirement.

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Comparability Dutch Case

Re-distribution requirement

One of the key requirements for comparability with a Dutch FBI is the re-distribution requirement.

In case law (the Finnish investment fund case), the Dutch Supreme Court (the highest court in the Netherlands) confirmed that for comparability, the re-distribution requirement is relevant. In the Finnish case, the Finnish fund did not meet the re-distribution requirement as it did not re-distributed its income within a certain limited period of time.

The Supreme Court ruled that as a result, the Finnish fund could not be comparable with the Dutch FBI. From this case we infer that not meeting the re-distribution requirement means a full stop in comparability.

<u>FBI regime</u>

Under the Dutch regime, an FBI is required to re-distribute its entire income within eight months after the close of its financial year. There are therefore two components of the requirement: there is a timing aspect (within eight months) and an income aspect (the entire income).

Failing to meet this requirement will result in losing the benefits of the FBI regime. This requirement has been put in place to avoid tax planning (i.e. using the FBI as a tax deferral vehicle as it is taxed against at 0% rate).

<u>US RIC regime</u>

Under the income distribution requirement, a RIC is required to distribute at least 90% of its investment company taxable income (ICTI) earned in its financial year within twelve months after the end of the financial year. Income that has been re-distributed is tax deductible. This way, tax neutrality is ensured when pooling investments through an RIC. In practice however, RICs distribute 100% of their ICTI to avoid taxation. If the other 10% of the ICTI is not re-distributed, this income will be taxable at the level of the RIC.

Comparability Dutch Case

Shareholder requirement

The Dutch tax administration indicated in several discussions that this is one of the key requirements. This is also the requirement that so far, caused the most issues since gathering the information proves to be very difficult due to, among others, the number of shareholders.

<u>FBI regime</u>

According to the Dutch legislation in place, a FBI should be in a position to disclose its shareholders. This rule is specifically applied to non-listed FBIs. This rule aims to controlling the number of investors and the “quality” of the investors (individuals predominantly).

<u>US RIC regime</u>

There is not specific requirement set in the Investment Company Act of 1940 or any other relevant legislation with regards to the number of investors in a fund. Indirect regulation via the “diversification rule”.

Comparability Dutch Case

Equal Profit distribution requirement

The purpose of this requirement is to prevent abuse structures. In the past, structures have been set up where Dutch shareholders would receive dividends on their shares (taxable but possibility to offset the Dutch dividend tax with income tax / corporate tax), whereas non-residents received a share premium payment (not subject to Dutch dividend withholding tax). To avoid these structures, a rule has been introduced that all shares should receive equal profits.

There are indications in literature that this requirement will only be held against funds that are aiming to avoid taxation and are structured in such manner that payments to non-residents are not subject to withholding tax (similar to the above structure). In situations where it is desired to issue different classes of shares whilst there is no tax avoidance aim, this requirement should not be causing restrictions. However, since this is not embedded in the law, the Dutch tax administration takes the position that this requirement should be met, regardless of the absence of any tax avoidance motives. For funds that have different series and / or classes of shares, they were arguing that the equal profit distribution requirement is not met.

US RICs regime

Most US fund that are qualifying for a RIC status have different classes of shares. Those different classes of shares are created in order to meet the specific needs of different types of investors, but not to avoid taxation. Furthermore, all general expenses are attributed to all share classes and are included in the general P&L. Only for class specific fees (such as fees for maintaining a college savings plan), a distinction is made per fund. As a result, the overall net payment can differ from share class to share class. We therefore argued that the existence of different classes of shares and the allocation of class specific fees, which may result in a different profit distribution, is not aimed at tax avoidance and that consequently, this requirement should not hinder the comparability of the funds with a Dutch FBI.

THANK YOU

Do not hesitate to contact us if you have questions

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