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A legal update from Dechert's International and Domestic Tax Group

ECJ Decision of 10 May 2012 in Santander Case: French Withholding Tax on Dividend Payments to Non-French Resident Investment Vehicles Is Not Compatible With EU Regulations

Domestic withholding tax imposed by EU Member States on dividend payments made to non-resident investment vehicles has been an ongoing issue for some time now, due to the argument that such taxes may restrict the free movement of capital within the EU. The European Court of Justice ("ECJ") recently handed down a major decision regarding this matter, finding that the French withholding tax ("WHT") levied on dividend payments by French-resident companies to non-resident investment vehicles is not compatible with EU law.

This decision not only relates to the right to refunds of WHT from French company dividends, but also provides a basis for seeking refunds of WHT from other EU-based companies, where the WHT has been imposed on a basis similar to that employed by France.

Background

The French Tax Code imposes a 30% withholding tax on dividend payments made by French-resident companies to non-resident investment vehicles. Prior to 1 January 2012, this tax was levied at the rate of 25%.

In the instant case, Belgian, German, Spanish and U.S. investment vehicles that were subject to the WHT brought a claim before a French administrative court, arguing that the tax was not compatible with EU regulations, since French investment vehicles were not subject to either corporate income tax or the WHT. The French court referred this to the ECJ.

ECJ Decision

The ECJ held that the difference in treatment with respect to imposition of the WHT upon resident and non-resident investment vehicles constituted a restriction of the free movement of capital, insofar as it could discourage non-resident investment vehicles from investing in French companies and French investors from investing in non-resident investment vehicles.

Moreover, the ECJ stated that this restriction could not be justified by:

- the particular tax circumstances of the investors in the investment vehicles (i.e. whether they were individuals or companies, subject to tax on dividend payments received from the investment vehicles, tax-resident in France or abroad);
- the need to guarantee the effectiveness of tax audits of the investment vehicles; or
- any overriding reasons in the public interest that the French government could provide.

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The ECJ concluded that non-resident and resident investment vehicles should be considered as comparable and that the difference in the WHT treatment could not be supported upon any of the foregoing grounds.

Finally, the ECJ stated that its decision had retroactive effect.

As a consequence, the French tax authorities were not entitled to withhold any tax, and comparable non-resident investment vehicles can make a claim for the refund of the French tax previously withheld.

Implications

This decision has very broad scope, as it applies to investment vehicles, including those incorporated in the form of mutual funds and whether located within or outside of the EU. While the ECJ did not provide clear guidance on what funds were "comparable" to French funds, it is possible that the decision also extends to private funds.

As the ECJ holding is broadly applicable to dividends paid to investment vehicles resident in foreign countries, without regard to whether or not such countries have established tax treaties with France, it is our belief that an entity located in a tax haven jurisdiction could seek to obtain a refund of the tax withheld, unless the entity is located in a non-cooperative Territory or State, provided that the entity can demonstrate that it has the status of an investment fund that is "comparable" to a French investment vehicle.

To date, many non-resident investment vehicles have filed refund claims with the French tax authorities. The French tax authorities have either rejected or not yet responded to such claims. In light of the ECJ decision, the French tax authorities no longer have a basis to reject such claims.

Although the ECJ decision involved the French WHT, the ruling should be applicable to other EU Member States as well. Accordingly, EU Member States that impose a WHT with respect to dividend payments made to non-resident investment vehicles – but not to resident investment vehicles – presumably will soon take steps to amend their legislation so as to be in conformity with EU law.

In the interim, this case provides a basis for claiming refunds of any WHT imposed on the basis that the recipient was a non-resident of the country concerned.

Respecting the future of WHT in France, newly elected French President Hollande has already announced that the French tax legislation should be amended this summer, in order to comply with the European regulations. It could be expected that, in amending the legislation, the French government will either (i) remove the imposition of WHT on dividend payments made to non-resident investment vehicles or (ii) enact a requirement to impose WHT on all dividend payments made by French companies, to both French and foreign investment vehicles.

In the current economic environment, it may be anticipated that the French government will not repeal the WHT. It is more likely that a WHT will become applicable to every dividend payment made by a French company to an investment vehicle, resident or not.

This future amendment, however, will not affect the ability of non-resident investment vehicles to claim refunds of tax withheld prior to the effectiveness of such amendment.

Please contact us if you would like any further guidance regarding the implications of the ECJ decision.

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