Foreign real estate funds eligible for Dutch FBI tax exemption

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In Brief

On 23 November 2018, the Lower Court in Breda, the Netherlands, decided that a German Open-Ended Public Fund (represented by PwC) was entitled to the FBI regime providing, among others, for a 0% Corporate Income Tax (CIT) rate on Dutch source real estate income. The Court also ruled that the portfolio investment test (one of the requirements of the Dutch FBI regime) should apply only to the Dutch real estate activities. The German fund held a large portfolio of Dutch real estate investments and was assessed with Dutch CIT on Dutch source real estate income in the years 1996-2010. The FBI regime is a facility in the Dutch CIT Act that can be applied by listed and non-listed (real estate) investment funds such as CIVs and REITs.

Object and purpose of the FBI regime

In the case at hand, the Dutch tax authorities (DTA) took the position that the German fund was not eligible for the FBI regime as the (German) investors were neither subject to Dutch dividend withholding tax nor to German income tax over the Dutch source real estate income. According to the DTA, the application of the FBI regime under these circumstances would be contrary to the object and purpose of the Dutch CIT Act (CITA). However, the Court rejected this argument, since the requirements for the FBI regime, as laid down in the Dutch CITA, do not require the shareholders of the FBI be subject to (withholding) tax.

Comparable legal form

For the years starting on or after 1 August 2007, the DTA took the position that, although the Dutch CITA allows entities incorporated under the laws of another EU Member State to elect for the FBI status, such entity can on the basis of the wording of the law only elect for the FBI regime if it finds itself under the same circumstances as an entity under Dutch law. The Court rejected this argument, as the law does not require that the non-Dutch entities shall find themselves exactly at the same circumstances as an entity under Dutch law.

On the contrary, for the years starting prior to 1 August 2007, Dutch tax law required that a FBI be incorporated under Dutch law. Therefore, for these years the German fund would not qualify for the FBI regime. According to the Court, such disqualification of funds incorporated or governed by foreign law constitutes a restriction on the free movement of capital. In addition, and contrary to the opinion of the DTA, the Court considered the German fund be objectively comparable to a Dutch FBI. With reference to the recent Court of Justice of the EU (CJEU) judgment in the *Fidelity Funds* case (C-480/16), the Court concluded that the fact that the taxation of the income of the German fund is not shifted to the level of the investors does not make such fund objectively incomparable with a Dutch fund. In addition, the Court concluded that there are no valid justification grounds for not applying the FBI regime to the German fund.

Moreover, the Court considered that not applying the 0% CIT rate to the German fund would result in economic double taxation of Dutch individual investors investing in Dutch real estate through the German fund. For non-Dutch individual investors, the Court concluded that an investment in Dutch real estate through the German fund results in a higher amount of Dutch taxation than in case of an investment by the same investors through a Dutch FBI. Given these circumstances, the argument that the purpose of the FBI regime aims to achieve fiscal neutrality cannot be used to deny the application of the FBI regime to the German fund.

Portfolio investment test

Under Dutch tax law, the activities of a FBI must solely consist of portfolio investment activities. The Court considered that this test should apply based on Dutch law and Dutch case law. According to the Court, the burden of proof that the activities consist solely of portfolio investment under Dutch tax law lies on the taxpayer. In that regard, the DTA took the position that the activities of the German fund go beyond the level of portfolio investments. Based on the facts presented by both parties, the Court decided that the activities of the German fund, as far as it consists of purchasing, renting out and selling real estate, qualifies as portfolio investment activities. However, with respect to the German fund's activities of entering into so-called "turn-key" projects with development companies, the Court considered that these activities fall within a grey area. Based on the limited information available to the Court as to the actual activities of the taxpayer in relation to these projects, the Court decided that the taxpayer did not deliver the required proof that the activities did not go beyond portfolio investment activities.

Furthermore, the German fund claimed that it does fulfil the investment test for German tax purposes on a global basis. The German fund claimed that based on EU case law the investment test for Dutch tax purposes should only apply on the Dutch activities of the German fund. The DTA, however, claimed that all activities (including those in other territories) should fulfil the investment test for Dutch tax purposes. The Court considered that, although applying the Dutch investment test on a global basis may not be considered discriminatory per se, such application may be considered in conflict with the free movement of capital based on the CJEU judgment in the *Van der Weegen* case (C-580/15). Although the Court was not without doubt as to its interpretation of EU law, it sought for a fair balance between the tax sovereignty of EU Member States and the free movement of capital. It thus ruled that a German fund fulfilling the investment test requirement for German tax purposes is required to meet the investment test for Dutch tax purposes only for its Dutch activities.

Finally, the German fund claimed that, should the Court decide that (part of) its activities go beyond portfolio investment activities for Dutch tax purposes, based on the principle of equality, it should still be entitled to the FBI regime. The German fund provided public information (annual reports) as to the activities of four Dutch FBIs from which it appears that these FBIs were engaged in property development activities in the years up to 2007. The German fund claimed that the DTA were applying the investment test less strictly to Dutch FBIs than to the German fund, which is in conflict with the principle of equality. In that regard, the Court decided on the basis of the non-contested facts presented by the German fund that based on the principle of equality the German fund does comply with the investment test for the years starting before 1 August 2007. For the years starting on or after 1 August 2007, the Court ruled that the German fund did not substantiate that the principle of equality is violated, because from these years FBIs were allowed to engage in property development activities through a taxable development subsidiary. Taking all of the above into account, the Court decided that in years starting on or after 1 August 2007 in which the German fund engaged in "turn-key projects" in relation to Dutch real estate, it did not deliver the required proof that the activities did not go beyond portfolio investment activities so to apply for the FBI regime.

State aid

The DTA claimed that granting the FBI regime to the German fund without the taxation of the income of the fund being shifted to the investors, would constitute State aid. The Court did not uphold this argument based on a number of reasons, including that the DTA did not sufficiently substantiate their position.

Our view

The EU Member States are increasingly challenged as to the tax treatment of investment funds making investments into their country. In the *Fidelity Funds* case, the CJEU decided that source states may not deny a tax exemption to non-resident funds while exempting resident funds. The fact that the investors in the non-resident fund are not subject to tax in the source state is no valid justification for denying the tax exemption. A fund investing in another EU Member State should consider filing objections against tax assessments in the source state if funds resident of such source state would be exempt from such tax.

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