KEEPING MORE OF WHAT'S OURS:

WITHHOLDING REFUNDS AND EXEMPTIONS IN EUROPEAN UNION INVESTMENTS FOR PUBLIC PENSION FUNDS

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ABSTRACT

Public pensions in the United States are tax-exempt entities. With respect to US-based investments, funds work with local tax authorities to obtain withholding exemptions on their investment returns. Pensions have not had similar success, however, in obtaining tax-exempt status for European holdings. Recent European Union case law may present an opportunity for US-based funds to avail themselves of free movement of capital and anti-discrimination principles in EU treaties. In a series of cases, European courts have interpreted these principles to apply not only to EU countries, but non-EU countries as well. This Note argues that US-based funds are bound by their fiduciary duty to pursue tax-exempt status and a refund of taxes previously withheld. These positive developments will benefit current and former workers who depend on pension income in retirement.

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INTRODUCTION

Recent EU case law could mean that US-based public pension funds are entitled to refunds for taxes withheld with respect to some of their European investments. The European Court of Justice ("ECJ") has held that taxing authorities are not allowed to apply discriminatory tax withholding practices to foreign-based entities where a similar local entity would be tax-exempt.[1] Public pension funds located in the United States can use this precedent to obtain similar preferential tax treatment, already enjoyed by European-based public pension funds, on the ground that taxing two similar pension entities is also discriminatory.[2]

Those responsible for managing public pension assets have a fiduciary duty to act for the sole benefit of plan beneficiaries.[3]

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[1] *See generally* Case C-303/07, Aberdeen Prop. Fininvest Alpha Oy, 2009 E.C.R. I-05145.

[2] *The European Court of Justice Delivered its Final Judgement in the Aberdeen (C-303/07) Case*, EU DIRECT TAX GROUP NEWSALERT (PricewaterhouseCoopers, London, U.K.) (June 18, 2009), *available at* https://www.pwc.com/en_GX/GX/eu-tax-news/pdf/pwc-eudtg-newsalert-2009-010.pdf.

[3] *See generally* RESTATEMENT (THIRD) OF TRUSTS § 78 (2007).

Minimizing a pension fund's expenses and liabilities is an example of conduct the duty requires.[4] To this end, plan trustees should petition European governments for tax-exempt status, as well as for refunds on withholding taxes already paid, on the basis of anti-discrimination principles as codified in EU founding documents and recent case law.[5] These refunds, and a tax-exempt status on a forward-looking basis, will benefit current and former US-based public employees who participate in these retirement plans, thereby maximizing the overall level of payouts. In Wisconsin alone, more than 570,000 current and former public employees have contributed to the Wisconsin Retirement System.[6] These employees, and millions more across the United States, could potentially realize significant returns. Furthermore, trustees will fulfill their fiduciary duty and avoid any liability for failing to act in the best interests of plan beneficiaries.

Pension plans in the United States generally enjoy tax-exempt status when making US-based investments.[7] Although European pension funds are tax-exempt when making investments within the European Monetary Union, US-based funds making investments in European companies or other European-based assets are subject to European withholding taxes on dividends issued by the underlying companies.[8] Various institutional investors domiciled in one European Union country, but doing business in another, have similarly been subject to withholding taxes. Over the past few years, these investors have achieved numerous victories in the European Court of Justice, entitling them to refunds on foreign taxes withheld.[9]

Two cases highlight the developments that will benefit US public pensions. A 2009 ECJ case ("Aberdeen Property Fininvest Alpha Oy") involved a Finnish real-estate company that was a wholly owned subsidiary of a Luxemburg-based investment fund. While a Finnish

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[4] *Id.*

[5] Consolidated Version of the Treaty on the Functioning of the European Union arts. 63, 65, Oct. 26, 2012, 2012 O.J. (C 326) 1 [hereinafter Consolidated Treaty].

[6] WIS. RET. SYS., STATE OF WIS. INV. BD., INVESTING FOR YOUR RETIREMENT, 1 (2012), *available at* http://www.swib.state.wi.us/WRS%20BROCHURE%20-%202012.pdf.

[7] 26 U.S.C. § 401(a) (2013).

[8] EU DIRECT TAX GROUP NEWSALERT, *supra* note 2.

[9] *See generally* Case C-338/11, Director des residents a l'etranger et des services generaux; Santander Asset Mgmt. SGIIC SA & Others (C-339/11 to C-347/11) v. Ministre du Budget, des Comtes publics, de la Fonction publique et de las Reforme de l'Etat. Joined Cases C-338/11 to C-347/11 Santander Asset Mgmt. SGIIC & Others, 2012 E.C.R. I-0000 [hereinafter Case C-338/11, Santander Asset Mgmt., 2012 E.C.R. I-0000].

parent company would have enjoyed tax-exempt status because the dividends flowed to a foreign-based parent, Finland applied withholding tax to the dividend payments.[10] The European Court of Justice held that entities that are substantially similar are entitled to equal tax treatment; in other words, because the Luxemburg-based parent would have been tax-exempt if domiciled in Finland, it was entitled to tax-exempt status.[11]

Significantly, however, the decision did not address open-ended funds commonly referred to (in Europe) as "unit trusts."[12] An open-ended fund is one an investor may enter or exit freely. A US-based institutional investor, like a pension fund, would be considered a unit trust.[13] In 2012, the ECJ addressed this situation. In the *Santander* case, the ECJ examined the French government's withholding tax system as it applied to investment funds located outside of France.[14] In *Santander*, no local subsidiary was present. The fund subject to withholding tax was only connected to the taxing jurisdiction through its investment in a French company paying dividends.[15] This is an important development, as US-based funds often make direct investments in foreign companies as opposed to investing through a foreign-based subsidiary.

Both the *Aberdeen* and *Santander* decisions were based on EU anti-discrimination and freedom of capital movement law.[16] The question is whether European taxing authorities would be sympathetic to identical claims from US-based funds, and in the event they were not, whether those funds could persuade a European court to extend its analysis and also hold that the same anti-discrimination laws guarantee US-based pensions a tax-exempt status.[17]

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[10] Case C-303/07, Aberdeen Prop. Fininvest Alpha Oy, 2009 E.C.R. I-05145.

[11] *Id.*

[12] Ted Dougherty et al., Deloitte, *EU Law Based Withholding Tax Claims Recovery of the "Unrecoverable,"* FAIRVIEW FUND ADMIN., http://fairviewfundadmin.com/eu-law-based-withholding-tax-claims-recovery-of-the-unrecoverable/ (last visited Apr. 14, 2016).

[13] *See id.*

[14] *Id.*

[15] *See generally Santander Case: Refund of French Dividend Tax to Foreign Investment Funds*, LOYENS & LOEFF (May 11, 2012), *available at* http://loyensloeffwebsite.blob.core.windows.net/media/1908/brazildeskemailbulletin20.pdf.

[16] *Id.*

[17] FRESHFIELDS BRUCKHAUS DERINGER, EU TAX LAW: SANTANDER CASE/REFUND OF DIVIDEND WITHHOLDING TAX TO NON-RESIDENT COLLECTIVE INVESTMENT VEHICLES 4 (May 2012), *available at* http://www.freshfields.com/uploadedFiles/SiteWide/Knowledge/EU%20tax%20law%20Santander%20case.pdf.

These cases represent a positive shift in EU case law and tax policy, the trajectory of which serves as an indication that US-based pension funds are entitled to refunds on previously withheld taxes, as well as tax-exempt status on a go-forward basis. Furthermore, in a lower-court opinion in the *Santander* case, the French court indicated that the same anti-discriminatory treatment should be applied to investment funds located both inside and outside the European Union.[18]

Part I of this Note begins with a primer on the fiduciary duties of pension trustees and continues with an exploration of the statutory basis the ECJ has relied on to grant foreign entities, which are similar to tax-exempt domestic entities, tax-exempt status on the basis of freedom of establishment and free movement of capital principles. Part I next explores the development of case law, focusing on the ECJ's 2009 decision in *Aberdeen*, as well as the court's 2012 decision in *Santander*. Part II connects these decisions to public pension funds located in the United States, predicting that European governments would be amenable to tax-refund claims from US-based public pension funds, or in the alternative, that the ECJ would grant similar tax-exempt status. Part II next explores the use of alternative tax structures that would reduce the usefulness of the *Aberdeen* and *Santander* decisions, and as a corollary, the possibility that a European legislature could structure their withholding tax in such a way as to avoid the holdings. Finally, Part III concludes with a call to action for US-based public pension funds to seek refunds of European withholding taxes in an effort to fulfill their fiduciary duties to plan beneficiaries and maximize the return of the fund.

I. BACKGROUND

A. TRUSTEE FIDUCIARY DUTIES: A PRIMER

Two important fiduciary duties applicable to public pension funds are the duties of loyalty and prudent investment. The prudent investor standard applicable to Wisconsin's public pension fund—the State of Wisconsin Investment Board ("SWIB")—is codified in Wis. Stat. 25.15(2)(a) and requires SWIB to manage trust assets with the prudence of a person acting in a similar capacity.[19] The duty of loyalty is

[18] Dougherty et al., *supra* note 12.

[19] WIS. STAT. § 25.15(2)(a) (2014).

codified in Wis. Stat. 25.15(2)(c). This statute requires SWIB to invest for the sole benefit of plan beneficiaries.[20] These important statutes are at the foundation of one of this Note's main arguments—that pension plans are *required to* pursue tax-exempt status as well as refunds for taxes already paid to European governments. One may wonder what makes these investments beneficial if trustees have to go through the hassle of seeking refunds and tax-exempt status. The answer is: *they must*. Trustees are required to diversify, which includes a broad mandate to invest in companies located outside the United States. This concept will be explored in greater depth in the following pages.

1. The Duty of Prudence

Modern Portfolio Theory ("MPT") is now incorporated in the prudent investor standard, and imposes a duty to diversify investments and requires that each investment be chosen with consideration towards enhancing the overall portfolio value in light of plan objectives and risk appetite.[21]

MPT provides trustees with more investment options—the use of derivatives, for example—than the old common-law standard, which looked at the prudence of each individual investment in isolation.[22] Diversification, a core requirement of MPT, ensures lower overall risk and volatility and in practice means that courts reviewing a trustee's investment decisions will look to the challenged investment's role in the overall investment strategy.[23] Thus, investments that may have been imprudent when viewed in isolation (a put option,[24] perhaps) could be prudent when made as a hedge meant to reduce the risk of owning the underlying security. Even though fulfilling the duty to diversify may open the door to more investment alternatives, there are still strong safeguards in place to protect beneficiaries' interests.[25]

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20 WIS. STAT. § 25.15(2)(c) (2014).

21 Jose Martin Jara, *What is the Correct Standard of Prudence in Employer Stock Cases?*, 45 MARSHALL L. REV 541, 565 (2012).

22 *See, e.g.*, *In re* Ford Motor Co. ERISA Litig., 590 F. Supp. 2d 883, 895 (E.D. Mich. 2008).

23 *See, e.g.*, *id.*

24 A put option gives the owner the right, but not the obligation, to sell a security at a future date for a pre-determined price. *See Put Option*, WIKIPEDIA, http://en.wikipedia.org/wiki/Put_option (last visited Mar. 21, 2015).

25 Uzyel v. Kadisha, 116 Cal. Rptr. 3d 244, 283 (Cal. Ct. App. 2010).

The prudent investor standard affords trustees great discretion in making investment decisions.[26] The diversification requirement does not prescribe the exact way to achieve diversification; rather, it affords fiduciaries flexibility to develop an investment program that achieves the stated risk/return goals and objectives of the trust fund.[27] This flexibility means trustees can invest in, for example, foreign-based partnerships and other so-called alternative investments which, at the risk of oversimplification of what can be very complex investment vehicles, is what the *Aberdeen* and *Santander* cases involve. This Note will look at the precise nature of the entities involved in those cases in another section.

Courts have been reluctant to second-guess a fiduciary's individual investment decisions, reserving judgment for situations in which a fiduciary's investments threaten the solvency of the plan as a whole.[28] For example, in an ERISA[29] context, plan beneficiaries lacked standing when they could not show that an imprudent investment threatened the financial integrity of the entire plan.[30] Furthermore, plan fiduciaries who fail to properly investigate are insulated from liability if a hypothetically prudent investor would have made the same decision anyway.[31] Finally, a mere decline in the value of an investment is insufficient for liability "absent [a fiduciary's] knowledge of impending collapse or other impropriety."[32] These examples highlight the extent to which courts balance the competing interests of promoting flexibility and fiduciary accountability.

a. *Tatum v. R.J. Reynolds*: Procedural and Substantive Prudence

This case involved a trustee's decision to eliminate an Employee Stock Ownership Plan ("ESOP") as an investment option for employees.[33] Plan administrators developed a timeline for completing the

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26 San Mateo Union High Sch. Dist. v. Cnty. of San Mateo, 152 Cal. Rptr. 3d 530, 541 (Cal. Ct. App. 2013) (indicating a flexible application of the prudent investor standard).

27 Pension Benefit Guar. Corp. v. Morgan Stanley Inv. Mgmt., 712 F.3d 705, 717 (2d Cir. 2013).

28 Hill v. Vanderbilt Capital Advisors, 834 F. Supp. 2d 1228, 1254–55 (D.N.M. 2011).

29 ERISA refers to the Employee Retirement Income Security Act and governs, among other things, private employer-sponsored pension plans. *See Health Plans & Benefits: ERISA*¸ U.S. DEP'T LAB., http://www.dol.gov/general/topic/health-plans/erisa (last visited Mar. 21, 2015).

30 *Id.*

31 Tatum v. R.J. Reynolds Tobacco Co., 926 F. Supp. 2d 648, 678 (M.D.N.C. 2013).

32 *In re* Harley Davidson, Inc. Sec. Litig., 660 F. Supp. 2d 953, 967 (E.D. Wis. 2009).

33 *Tatum*, 926 F. Supp. 2d at 668.

phase-out and communicated their plan to employees.[34] At the prescribed deadline, the stock was sold at what turned out to be the bottom of a very steep decline.[35] Two months later, shares began to rise, and eight months later, Nabisco and R.J. Reynolds stock had increased 247% and 82% respectively.[36] The plan participants sued, alleging trustees failed to investigate or analyze whether removing company stock from the retirement plan was in the best interest of the beneficiaries.[37]

The Court divided its analysis between procedural and substantive prudence. Procedural prudence looked at how the trustees reach their decision, while substantive prudence asked whether that decision caused the plaintiff's loss.[38] The trustees failed to fulfill their procedural prudence duties by relying on assumptions as opposed to research, failing to consider reasonable alternatives to a course of action, and not monitoring the prudence of each investment option available to plan participants.[39] Particularly disconcerting was the fact that the assumptions on which trustees relied were incorrect. Trustees mistakenly assumed that, by virtue of a corporate spinoff, the stock held in the plan would no longer be exempt from ERISA diversification requirements.[40] By relying on this assumption, without making any attempt to ascertain its truth, the court determined the trustees' failed to investigate.[41] Finally, trustees had considered their own liability when deciding to eliminate company stock from the retirement plan, a violation of the duty of loyalty.[42]

Finding a lack of procedural prudence, however, does not automatically result in liability: a causal connection—substantive prudence—is necessary.[43] Because of the risks involved in having a retirement plan with a single stock, it *was* prudent for the plan fiduciaries to liquidate those assets, even though the process used to arrive at that decision was flawed.[44] Investment decisions are not evaluated through the clear lens of hindsight; rather, courts look at what was known when

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[34] *Id.* at 679.
[35] *Id.* at 665.
[36] *Id.* at 666.
[37] *Id.* at 669.
[38] *Id.*
[39] *Id.* at 680–81.
[40] *Id.*
[41] *Id.* at 682.
[42] *Id.* at 681.
[43] *Id.* at 682.
[44] *Id.* at 684.

the decision was made.[45] Courts will not substitute their own judgment when it comes to market-timing mistakes. Conduct that occurs as a result of a faulty process will be excused if a prudent fiduciary would have reached that conclusion anyway. Because the trustees' breach of their duty of prudence did not ultimately cause the Plaintiff's loss, the Plaintiff's claim failed.

The case is important for this Note's purposes because it establishes that a trustee is greatly restricted in his or her ability to consider the burden of a task in determining a course of action; in fact, they cannot consider it at all. Once again, the duty of loyalty requires the trustee to act for the sole benefit of plan beneficiaries.

2. The Duty of Loyalty

The duty of loyalty "is the most fundamental duty of a trustee."[46] The duty requires the trustee to manage trust assets for the sole benefit of the beneficiaries.[47] The fiduciary duty trustees owe beneficiaries is one of the most stringent the law imposes. This is due in large part to the relative vulnerability of trust beneficiaries to abuses perpetrated by trustees. Trustees often act with little oversight and have access to funds that do not belong to them, while beneficiaries frequently lack the expertise to adequately assess a trustee's decisions.[48] A few cases highlight some abuses by trustees and the high standard to which the law holds trustees.

a. *Uzyel v. Kadisha*: When Fiduciary Duties Conflict

Uzyel involved a trustee's use of trust assets for personal gain.[49] After the untimely death of her husband, Plaintiff entrusted Defendant to oversee two trusts set up to support her and her children.[50] Defendant, an entrepreneur, took loans without permission from the trust to pay off his own personal debt. This plan enabled him to invest some of his own personal funds in then-risky startup Qualcomm.[51] Qualcomm became

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45 *Id.* at 669.
46 *Uzyel*, 188 Cal. App. 4th at 905.
47 *Id.*
48 *Id.*
49 *Id.* at 902.
50 *Id.* at 879.
51 *Id.* at 880–84.

very successful, after which Plaintiff sought disgorgement of profits, totaling millions, on the basis that the Defendant breached his duty of loyalty. The Defendant maintained that he acted prudently in his investments, asserting that he never directly used trust money to buy the stock and that he paid back the loans with interest.[52]

The Court held that to allow a trustee who uses trust assets for his own personal gain to defeat the duty of loyalty by asserting that the transaction was justified (or required) by the duty to invest prudently would "seriously undermine the duty of loyalty and impair its deterrent value."[53] The prudence of an investment is assessed at the time the investment was made. Furthermore, under the "no further inquiry" rule the Defendant is liable for breach of the duty of loyalty even if he acts in good faith, the terms of the deal are fair, or he earns no profit by investing in the Qualcomm stock.[54] Here, the duty to make prudent investments could not be used as a defense to a breach of the duty of loyalty.

Uzyel also provides a basis for this Note's argument that trustees are required to utilize foreign alternative investments to achieve their diversification requirement. Because of this, a trustee cannot simply invest in US securities in an attempt to avoid the extra effort that may come with seeking refunds and tax-exempt status in a foreign jurisdiction. A second case shows how a court would analyze an alleged breach of the duty to invest prudently.

B. *ABERDEEN* AND *SANTANDER* AND *FOKUS BANK:* FACTUAL HISTORY AND STATUTORY BACKGROUND

Before *Aberdeen* and *Santander*, there was a case called *Fokus Bank*.[55] *Fokus Bank* represents the first, though perhaps least important, case in a series of cases that trend in favor of public pension funds in the United States becoming tax exempt. Although the case is of relatively little precedential value for US-based funds, it represents one of the first times discriminatory withholding practices were challenged in Europe.[56]

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52 *Id.* at 883.
53 *Id.* at 906.
54 *Id. at 902.*
55 Case E-1/04, Fokus Bank ASA v. Norway, [2005] 1 C.M.L.R. 10 (Eur. Free Trade Area, Nov. 23, 2004).
56 *See generally id.*

The discriminatory withholding practice had a very benign basis. In *Fokus Bank*, Norway sought to avoid double taxation of dividends, first at the corporate level as profits and second at the individual level as income.[57] This was accomplished by granting residents of Norway a credit in the amount of tax paid at the corporate level. Non-residents, however, were unable to avail themselves of this credit, as they did not have Norwegian income-tax liability.[58] Instead, withholding on dividends paid to foreign shareholders was governed by agreements between EU member countries, often with both countries imposing a smaller tax than one country would on its own or allowing a credit for taxes already withheld.[59]

What is important about *Fokus Bank* for purposes of this Note is the taxpayer's argument that EU nondiscrimination law prevents Norway, or any other party to the European Economic Area Agreement ("EEA Agreement"), from applying one set of rules to domestic shareholders and another set to those in foreign countries.[60] Article 4 of the EEA Agreement provides that discrimination on the grounds of nationality is prohibited.[61] Furthermore, Article 40 prohibits discrimination with respect to the free movement of capital between member countries.[62] Next, the Court considered whether dividend payments fall within the purview of these provisions; that is, whether they constitute the movement of capital. Given the deterrent effect the withholding practice may have on foreign investors, the Court holds that the free movement of capital is implicated in the practice.[63] Although different non-discrimination treaties will ultimately apply in the *Aberdeen* and *Santander* cases, *Fokus Bank* lays important groundwork for getting to tax-exempt status for US-based pension funds.

The next step in the withholding case series is *Aberdeen*. The case involved a slightly more complex dividend payment arrangement: a Finish-based subsidiary paid dividends to a Luxembourg-based open-ended investment company.[64] Although no precise Finnish equivalent existed, had the Luxembourg-based fund been similarly arranged under

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57 *Id.* ¶ 9.
58 *Id.* ¶ 10.
59 *Id.* ¶ 11.
60 *Id.* ¶ 15.
61 Agreement of the European Economic Area art. 4, Mar. 1, 1994, 2012 O.J. (L 1) 3.
62 *Id.* art. 40.
63 Case E-1/04, Fokus Bank ASA, ¶ 34.
64 Case C-303/07, Aberdeen Prop. Fininvest Alpha Oy, 2009 E.C.R. I-05145, ¶¶ 12–13.

Finnish law, the dividend payments would have been tax-exempt.[65] Even though the structure was more complex, the fundamentals were the same—one tax regime applied to those locally domiciled and a different regime to those based abroad.

Another important development is that a different anti-discrimination treaty applied—one that will ultimately benefit countries that are not a party to it. Petitioner Aberdeen asserted anti-discriminatory arguments based on the European Community Treaty ("EC Treaty").[66] The applicable provisions of the EC Treaty are Articles 43 and 48, which are freedom of establishment provisions.[67] The *Aberdeen* Court ultimately decided the case on freedom of establishment grounds, but also noted that free movement of capital principles would lead to the same result.[68] The freedom of establishment argument is that an entity is free to conduct business through a subsidiary, branch, or agency.[69] Free movement of capital, of course, is how the *Fokus Bank* case was decided. The distinction is not material except to highlight that there are multiple ways of arriving at the same result. After *Aberdeen* was decided in 2009, it took another three years before a case directly applicable to US-funds found its way to the ECJ. This Note explores the *Santander* case in depth as it is the primary source of support for the thesis that public pension funds resident in the United States can obtain favorable tax treatment abroad.

II. ANALYSIS

This Note argues that, as a logical extension of the reasoning of the *Santander* case, public pension funds resident in the United States should not only be tax-exempt on a go-forward basis but also entitled to refunds for foreign dividend tax previously withheld. By now, the nature of the challenge and the legal arguments advanced should sound familiar. The *Santander* case involves a challenge to a French law applying a withholding tax of 25% on dividends paid to non-resident investment funds.[70] The broad question is whether this discriminatory tax treatment is in contravention of free movement of capital principles as codified

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65 *Id.*
66 *Id.* ¶ 13.
67 Consolidated Treaty, *supra* note 5, arts. 43, 48.
68 Case C-303/07, Aberdeen Prop. Fininvest Alpha Oy, 2009 E.C.R. I-05145, ¶ 28.
69 *Id.* ¶ 29.
70 Case C-338/11, Santander Asset Mgmt., 2012 E.C.R. I-0000, ¶ 6.

under Article 63 of the Treaty on the Functioning of the European Union ("TFEU").[71] It is worth noting that, under Article 63 of the TFEU, not all discriminatory tax practices are disallowed under the EU Treaty. There are two exceptions to the anti-discrimination rule: (1) situations in which the resident and nonresident investors are not in an "objectively comparable" situation, or (2) when the discriminatory treatment is justified by some overriding public policy concern.[72] These two issues are at the heart of ECJ's analysis and deserve separate and in-depth treatment.

As a preliminary matter, *Santander* is not an appeal from a lower French court's ruling in the way Americans would think of the Supreme Court reviewing the decision of a lower Court of Appeals. Rather, the French court has posed a question to the ECJ, seeking its guidance on the correct application of EU law. With courts in different countries applying the same EU laws, there is a risk of disparate decisions. The ECJ is charged with interpreting EU law so that it is uniformly applied across member countries.[73] As an enforcement mechanism, countries that do not follow the holdings of the ECJ can be fined for their noncompliance.[74] This was a situation in which the French court had purposely withheld its own judgment until it could get clarification on the correct application of the law from the ECJ.

A. DISCRIMINATORY TAX TREATMENT AND THE FREE MOVEMENT OF CAPITAL

State action that tends to discourage cross-border investment will likely run afoul of free movement of capital principles.[75] One of the primary goals of the European Monetary Union is to facilitate the free transfer of capital between member states.[76] At issue in the *Santander* case were Articles 63 and 65 of the TFEU. Article 63 prohibits discrimination generally, and Article 65 lays out the two exceptions described above, which are the "objectively comparable" exception and

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[71] Consolidated Treaty, *supra* note 5, art. 65.

[72] *Id.* art. 63.

[73] *Court of Justice of the European Union*, EUROPEAN UNION, http://europa.eu/about-eu/institutions-bodies/court-justice/index_en.htm, (last visited Jan. 15, 2015).

[74] *Id.*

[75] *See generally* Case C-338/11, Santander Asset Mgmt., 2012 E.C.R. I-0000.

[76] *Economic and Monetary Union (EMU)*, EUROPEAN CENTRAL BANK, https://www.ecb.europa.eu/ecb/history/emu/html/index.en.html (last visited Mar. 21, 2015).

the "public policy" exception.[77] The ECJ dispensed with this issue rather summarily, finding that because the French government applied a 25% withholding tax to dividends paid to non-resident Undertakings for Collective Investments in Transferrable Services ("UCITs"),[78] those funds would be less likely to invest in French companies.[79] Conversely, French-domiciled UCITs could be incentivized to invest funds in French companies to take advantage of the favorable tax treatment of dividends, with fewer dollars invested in the rest of the European Union, or even non-EU states.[80]

These disincentives to cross-border investments are precisely what Article 63 sought to prohibit, and there is well-established case law to that effect.[81] As such, the French legislation constitutes a restriction on the free movement of capital, which is presumed to be impermissible unless the legislation falls within one of the two Article 65 exceptions.[82] Because Article 65 sets forth two exceptions to the default free movement of capital principles as codified in Article 63, the ECJ applies a standard of review similar to that of strict scrutiny (an exacting form of judicial review in the United States that requires constitutionally suspect laws to fulfill a compelling government interest and be narrowly tailored in their approach): "in so far as Article 65(1)(a) TFEU is a derogation from the fundamental principle of the free movement of capital, it must be interpreted strictly."[83] Furthermore, Article 65(1) also provides that any national legislation that seeks to use the Article 65 exceptions cannot do so "as a means of arbitrary discrimination or a disguised restriction on the free movement of capital."[84] Given the exceptions but also the built-in cautionary language, it is clear that the Article 65 exceptions should apply only in rare and special circumstances. This is a significant barrier for the French government to overcome.

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77 Consolidated Treaty, *supra* note 5, art. 63.

78 UCITs are Undertakings for Collective Investment in Transferrable Securities. UCITs are creatures of European Union law and are simply investment vehicles. *Undertakings for Collective Investment in Transferrable Securities,* WIKIPEDIA, http://en.wikipedia.org/wiki/Undertakings_for_Collective_Investment_in_Transferable_Securities_Directives (last visited Mar. 21, 2015).

79 Case C-338/11, Santander Asset Mgmt., 2012 E.C.R. I-0000, ¶ 17.

80 *Id.*

81 *See, e.g.*, Case C-370/05 Festersen, 2007 E.C.R. I-1129, ¶ 24.

82 Case C-338/11, Santander Asset Mgmt., 2012 E.C.R. I-0000, ¶ 19.

83 *Id.* ¶ 21.

84 *Id.* ¶¶ 22–23.

B. OBJECTIVELY COMPARABLE SITUATIONS OF RESIDENT AND NON-RESIDENT INVESTORS

With respect to whether investors are in an objectively comparable situation, the first question is one of perspective. The French court sought clarification as to whether investors were comparable only by reference to the actual entity type, or whether the identity of the shareholders needed also be considered.[85] The latter inquiry could be complex, as in a situation where limited partners are themselves corporate entities, each domiciled in a different jurisdiction. The practical difference, it seems, is one of administrative ease. If we confine our analysis to the entity level, one determination will suffice. If, on the other hand, we make a determination for each individual investor, some will be exempt from withholding tax while others will not. The extra administrative work may pay off for the government by way of increased revenues. Given the sheer number of investors in some funds, however, a case-by-case determination may be administratively impractical.

The French government, likely in an attempt to maximize its tax revenue, argued that because the UCIT is a conduit through which investors act, the entity level is not an appropriate point of analysis. Because a UCIT is really acting on behalf of its investors, it makes sense to consider the tax situation of the investors themselves, not the vehicle through which they invest.[86] Furthermore, the French government asserted that non-resident investors would receive similar tax treatment through tax conventions between the French government and other EU-member and non-member states.[87] These tax conventions concern, among other things, the issue of double-taxation and generally mean that if the French government imposed a tax on French-sourced dividends for foreign investors, they would be tax-exempt in their home country.[88] This situation would not run afoul of free movement of capital principles because each investor is in theory exempt in his home country. The ECJ held, however, that this argument must fail because it is based on the faulty assumption that UCITs and their investors share a domicile. To the contrary, it is not uncommon to have French UCITs with foreign

[85] *Id.* ¶ 25.
[86] *Id.* ¶ 25.
[87] *Id.* ¶ 33.
[88] *Id.*

investors, or foreign UCITs with French investors. In those situations, the tax treatment would be dissimilar.[89]

The lower French court had noted that in the event the determination of whether two investors were in an objectively comparable situation was restricted to the entity level, that the result would invariably be one where the investors were always tax-exempt.[90] This is because the entity type involved in this litigation was a UCIT, a creature of European law, and a UCIT domiciled in one country is the same legal entity as that formed in another country.[91] Thus, the thinking is that similar entity types are always in a comparable situation.[92] The French court went one step further (muddying the issue in this author's mind), holding that where entities are in comparable situations, there can be no overriding public interest in different treatment. This statement misstates EU law; the two exceptions to the anti-discrimination rule require separate analyses, and indeed, the ECJ did exactly that in its opinion.[93]

The ECJ did not have to dive into the issue of the administrative difficulty of tracking down the domicile of each individual fund investor because the court dispensed with the issue by referring to the French statute itself.[94] The ECJ noted that the French legislation specifically references the UCIT's domicile, not that of its investors.[95] As such, it is inappropriate to consider the location of a UCIT's constituent investors.[96] This judicial decision-making process is similar to that typically exercised in US courts: look first to plain statutory language, and only if that is ambiguous do we then consider other factors. Therefore, the ECJ concluded that consideration regarding whether two UCITs were in an objectively comparable situation will be confined to the domicile of the UCIT and will not look to the domicile of its constituent investors.[97] With this determination, it readily followed that the situations of the UCITs involved in this litigation were objectively comparable, failing to satisfy one of the two exceptions to the general prohibition on the free

89 *Id.* ¶ 34.
90 *Id.* ¶ 8.
91 *See generally id.*
92 *Id.*
93 *See generally id.* ¶ 8.
94 *Id.* ¶ 28.
95 *Id.* ¶ 39.
96 *Id.* ¶ 41.
97 *Id.* ¶ 44.

movement of capital described above.[98] The next step for the ECJ was to determine whether there was any overriding public interest in the discriminatory tax treatment.

C. PUBLIC POLICY JUSTIFICATIONS FOR DISCRIMINATORY TAX TREATMENT

The French Government sought to assert a number of public policy—or perhaps national sovereignty—grounds arguing for the validity of the discriminatory tax treatment. Overriding public interest concerns would provide a basis for upholding the tax regime.[99] One recurring theme in EU cases is the level of national autonomy retained by the member state to pass laws as it sees fit. The court puts the French government's argument more eloquently when it summarizes the national sovereignty argument as a "need to safeguard the balanced allocation between the member states of the power to tax."[100] Also paramount to the French national interest is the "need to guarantee the effectiveness of fiscal supervision and the coherence of the tax system."[101] One strategic aspect of the French government's argument is that it asserts that its arguments respecting national sovereignty are stronger with respect to the litigants resident in non-EU states.[102] There is some logic to this assertion: the parties to EU treaties would perhaps expect that the provisions therein would have greater force when applied to disputes between member countries as opposed to non-member countries like the United States. I draw this distinction now because it has relevance to this Note's ultimate goal of extending the reasoning of this case to apply to not just UCITs located outside the European Union, but specifically to US-based pension funds. One important takeaway from the *Santander* case is that the court ultimately made no distinction between member states and non-member states in applying free movement of capital principles.[103] Stated another way, the French government's assertion that it should have greater leeway with respect to

[98] *Id.*
[99] *Id.* ¶ 45.
[100] *Id.* ¶ 46.
[101] *Id.*
[102] *Id.*
[103] *Id.* ¶¶ 47–49.

legislation that discriminates against non-member countries was rejected.[104]

With respect to the French government's argument that the discriminatory tax treatment "safeguards the balanced allocation between the member states of the power to tax," the ECJ noted that this argument may only be accepted where the regulation seeks to control activities in the member state's jurisdiction where those activities would undermine French sovereignty with respect to its taxation power.[105] It is ultimately improper for the French government to rely on this argument where it has undertaken, on its own, not to tax resident UCITs on the receipt of nationally-sourced dividend income.[106] Similarly, the French government cannot avail itself of the argument that discriminatory tax treatment ensures the effectiveness of fiscal supervision.[107] "As indeed the referring court notes, the effectiveness of fiscal supervision cannot justify taxation which affects solely and specifically non-residents."[108]

The court next turned to the French government's argument that the need to ensure the coherence of the French tax system justifies restrictions on free movement of capital. Case law respecting this issue is well settled in the European Union, and it requires a direct link between the "tax advantage concerned and the compensating of that advantage by a particular tax levy."[109] The French government established no such link, in that a resident's exemption from withholding tax (the "tax advantage concerned") is not conditional on redistribution ("compensating of that advantage") by the UCITs themselves.[110] In other words, the discriminatory tax legislation must be targeted at a party receiving an advantage and must be narrowly tailored to addressing that advantage. This was not the case here, as the discriminatory legislation at issue was precisely what was causing the tax advantage in the first place.[111]

In conclusion, the French government failed to effectively assert any overriding public interest in maintaining a discriminatory tax regime. As mentioned before, the absence of any differentiation between member and non-member states with respect to the applicability of free

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[104] *Id.*
[105] *Id.* ¶ 47.
[106] *Id.* ¶ 48.
[107] *Id.* ¶ 49.
[108] *Id.*
[109] *Id.* ¶ 51.
[110] *Id.* ¶ 52.
[111] *See generally id.* ¶¶ 52–53.

movement of capital principles indicates that a US-resident litigant may be successful in asserting a similar argument. For this reason, as well as others, *Santander* is an important case for this Note's main thesis.

D. APPLICATION OF THE *SANTANDER* FACTORS TO PENSION FUNDS RESIDENT IN THE UNITED STATES

It is by no means clear or accepted that US pension funds can enjoy tax-free dividends in reliance on the ECJ's opinion in *Santander*. That, of course, is this Note's main assertion. The application of the *Santander* factors will occupy the next several pages, broken down by the main *Santander* analysis sections above, and briefly summarized here for convenience. The analysis began with a look at free movement of capital principles and the discriminatory French tax regime's effects thereon. This Note next examined what constitutes objectively comparable situations, a key issue in determining whether there is facial discrimination under the challenged law. Finally, this Note examined the types of overriding public interests that may excuse legislation that restricts the free movement of capital respecting investors in objectively comparable situations by subjecting one group to a certain set of rules and another group to a less-favorable set of rules.

1. Free Movement of Capital Principles Applied to United States Funds

Recall that government action that tends to inhibit cross-border investment violates free movement of capital principles.[112] Given the ECJ's summary treatment of this issue in the *Santander* case, it seems that this is a low hurdle for a US-resident pension fund to surmount. Much like the UCITs at issue in the *Santander* case, a US-resident pension fund would be discouraged from making investments in EU member countries if the earnings on their investments will be subject to tax before leaving the country. Furthermore, given the favorable tax treatment enjoyed by local pension funds making local investments (in both the United States and the European Union), such discriminatory tax treatment runs counter to one of the foundational principles of the European Union, that of encouraging uninhibited investment and of securing for member countries the economic benefits flowing from such

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[112] *See supra* note 75.

free movement of capital.[113] This founding principle is codified in Article 65 of the TFEU,[114] and given the absence in the *Santander* decision of any distinction between member and non-member states, it readily follows that a future court would be willing to apply similar free movement of capital principles to litigants domiciled in non-member states. But that is only the first leg of the analysis, and, arguably, the easiest obstacle for a future litigant to overcome. Once legislation is deemed facially discriminatory, the court must then determine whether there are good reasons for allowing the law to stand. Above I referred to these as the "objectively comparable" and "public policy" exceptions, and this Note will now address each in turn.[115]

2. Whether United States Pension Funds May Point to European Counterparts in a Similarly Tax Favorable Situation to Avail Themselves of Anti-Discrimination Principles

This Note devoted a fair amount of space to the ECJ's consideration in the *Santander* case of what the appropriate vantage point for analyzing whether investors are in objectively comparable situations was—either at the investor or entity level.[116] Although the ECJ ultimately found a statutory basis for holding that the correct analysis is performed at the entity, and not the constituent investor, level, it signaled that it would have ruled similarly had there not been a statutory justification to resolve the issue. One of the French government's assertions was that resident UCITs and their constituent investors share a domicile, a faulty assumption that ignores the reality that it is exceedingly easy to make cross-border investments.[117] Even though the ECJ never explicitly stated as much in *Santander*, it stands to reason that tracking down individual investors spread all over the world, and applying a different set of rules to each of them depending on their country of domicile, would present an unworkable situation for courts analyzing challenged tax legislation in the future. The ECJ's focus on the entity level in *Santander* sets an important precedent. It means that a US-resident pension fund need not be concerned with finding a European counterpart with a similar profile

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113 *Economic and Monetary Union (EMU)*, https://www.ecb.europa.eu/ecb/history/emu/html/index.en.html (last visited Mar. 21, 2015).

114 Consolidated Treaty, *supra* note 5, art. 65.

115 *See supra* p. 132.

116 *See supra* pp. 132–35.

117 Case C-338/11, Santander Asset Mgmt., 2012 E.C.R. I-0000, ¶ 34.

of constituent investors. It will suffice to find a European pension fund that enjoys tax-favorable treatment of its earnings, a much simpler undertaking.

The Pension Fund Directive entered into force on September 23, 2005.[118] Only Italy, Denmark, and Sweden tax the investment results of pensions, but they are outliers in the European Union.[119] Otherwise, so-called "occupational pensions," also known as "second pillar pensions," enjoy tax-deductible contributions (by employer and employee), and tax-exempt investment results.[120] Like their US counterparts, distributions will be taxable to the recipient, to be included in the recipient's "gross income."[121] Although it is easy to find examples of both US and European pensions with similar characteristics, the focus of any court seeking to rule on whether two pensions are in an objectively comparable situation would focus on entity type.[122] Of course the legal designation attached to pension funds located in the United States and internationally will be as different as the laws of the respective countries, but that does not mean a comparison between countries will be wholly unsatisfactory.

Pension funds are usually run by an employer, either public or private, for the benefit of employees.[123] Simply due to the differing nature of international law, the public/private distinction is likely as granular a level of detail a court can go in analyzing whether two pensions are in an objectively comparable situation. In the United States, the Internal Revenue Code treats both public and private pensions similarly, provided private pensions are not "top heavy," which is to say that they do not unfairly benefit highly compensated employees.[124] Although comparing the precise tax treatment of domestic and foreign pension funds is a rabbit hole down which a European court would likely not descend, it nevertheless helps to establish that both public and private pensions enjoy tax-deferred status under the Internal Revenue Code, much like their European counterparts. Thus, a European court would likely find

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118 *Banking and Finance: Institutions for Occupational Retirement Provision (IORPs)*, EUROPEAN COMM'N, http://ec.europa.eu/finance/pensions/iorp/index_en.htm (last visited Mar. 21, 2015).

119 *Taxation and Customs Union: Pension Taxation*, EUROPEAN COMM'N, http://ec.europa.eu/taxation_customs/taxation/personal_tax/pensions/index_en.htm (last visited Mar. 21, 2015).

120 *Id.*

121 *Id.*; I.R.C. § 408(d)(1) (2006).

122 Case C-338/11, Santander Asset Mgmt., 2012 E.C.R. I-0000, ¶ 44.

123 *See generally* I.R.C. §§ 401, 408 (2006).

124 *Id.*

that pension funds residing in the United States are in an objectively comparable situation to their European-based counterpart.

3. Whether There Are Overriding Public Policy Reasons That Favor Allowing Discriminatory Tax Treatment

At first glance one might wonder whether a EU member state's sovereignty might be given greater weight when a litigant challenging the application of a particular discriminatory statute is not itself a member state. Recall that the court in *Santander* made no mention of differing standards to be applied for member and non-member states, even though the French government asserted that the discriminatory tax treatment "safeguards the balanced allocation *between the member states* of the power to tax."[125] This bodes well for US resident funds, as there is no higher bar to overcome on account of the fact that any potential litigant would be afforded the exact same treatment under European law as any other member state.

Because the ECJ did not indicate that it would engage in a separate analysis for member and non-member states, the arguments that the French government asserted in the *Santander* case in their attempt to establish the existence of overriding public policy reasons—justifying their discriminatory tax treatment—will be similarly unavailing in a case involving a US resident fund. The French government asserted three main arguments in its attempt to tax French-sourced dividends paid to foreign entities: (1) balanced allocation of power principles necessitated deference to the French legislation, (2) effective fiscal supervision similarly required deference to the law, and (3) the coherence of the French tax system would be threatened if the law was invalidated.[126]

These French sovereignty interests were rejected, largely because it was the French government's own discriminatory tax regime at issue, not the actions of third parties. Recall that the balanced allocation argument failed because the conduct regulated was the government's own, not that of investors. The fiscal supervision argument failed because the French government did not regulate all parties equally, and finally, the coherence argument failed because it was meant to remedy existing tax imbalances; it cannot be used to create one.[127]

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[125] Case C-338/11, Santander Asset Mgmt., 2012 E.C.R. I-0000, ¶ 47 (emphasis added).
[126] *Id.* ¶¶ 44–49.
[127] *See generally id.*

III. CONCLUSION

This Note's main assertion is that trustees of US-resident pension funds have a fiduciary obligation to pursue tax favorable status on a go-forward basis, as well as refunds for taxes paid to EU member countries who offer a similar tax-advantaged status for their own pension funds. This Note also argues that US resident funds will ultimately be successful in the endeavor. In support of this thesis, this Note developed a number of recent cases in the European Union, highlighting a positive trajectory in jurisprudence for US funds.

The first case in the series was *Fokus Bank*, which struck down a Norwegian practice of giving Norwegian investors a credit for corporate taxes paid on their personal returns, on the basis that parties to a certain treaty could not provide residents with a tax credit that would be unavailable to foreigners who had no local income-tax liability. Although of little precedential value for US funds, this was the first time the ECJ struck down a discriminatory tax practice on free movement of capital grounds. Next, and more significantly, *Aberdeen* involved a flow-through structure in which a foreign parent company was subject to tax while its local subsidiary was not. *Aberdeen* stood for the proposition that similarly situated entities are entitled to similar tax treatment, regardless of their country of domicile. *Aberdeen* was also decided on free movement of capital principles, like *Fokus Bank* before it. Thus, Finland could not provide tax favorable treatment to Finnish-resident entities, but it could impose tax on a similar entity located in a foreign country.

After a brief foray into fiduciary duty principles, which provided important foundational support for the argument that trustees are required to pursue a course of action that minimizes the tax hit borne by plan beneficiaries, this Note spent a significant amount of time analyzing the *Santander* case, which provides the strongest basis for achieving tax favorable treatment for US resident funds. Analyzing the three *Santander* factors, (1) whether free movement of capital principles is implicated by the state action, (2) whether a local entity enjoys tax favorable status where a similarly situated but foreign counterpart does not, and (3) whether, given that the first two elements are satisfied, the country has asserted an adequate justification in support of the discriminatory tax treatment, we can conclude that a US-resident fund would likely be able to successfully obtain a favorable tax status.

This Note then applied the three *Santander* factors to the specific situation of a US-domiciled fund, specifically finding that free movement of capital principles were at stake, that similar European entities exist and enjoy favorable tax treatment, and that no public policy considerations override fundamental anti-discrimination principles.

This Note concludes that a European court would likely rely on the *Santander* precedent and find favorably for US resident funds. Further, this Note calls trustees of US resident funds to affirmatively seek out tax refunds of previously withheld taxes, as well as advanced rulings providing them with tax-exempt status in all future dividend transactions in fulfillment of their fiduciary obligation to plan beneficiaries.