To what extent is tax still an issue for IORPs?

Tax obstacles are traditionally seen as a main barrier to pan-European pension funds. Stimulated by the European Commission and the European Court of Justice the Member States are changing their tax rules. The EFRP may speed up part of the process. **Peter Schonewille** reports.

There are two main tax obstacles for pan-European pension funds, or institutions for occupational retirement provision (IORPs) as they are called in the Pension Fund Directive. The first is the non-deductibility of pension contributions paid to foreign pension funds. The second is the taxation of pension capital transfers, when the pension capital is transferred to a foreign pension fund. The first obstacle is being removed with remarkable success. The second obstacle may follow suit, in response to complaints by the European Federation for Retirement Provision (EFRP). The state of play is set out below.

In 2001 in fourteen of the fifteen old Member States contributions paid to pension funds by employees and/or employers enjoyed some form of tax relief. In many instances this relief was only given for contributions made to domestic pension funds. Contributions to foreign funds had been excluded from the relief. This constituted an effective barrier to the functioning of pan-European funds: all things being equal, nobody would take out pension insurance from a foreign fund if they could not get the same tax subsidy as when dealing with a domestic fund.

Therefore, in parallel with the proposal for the Pension Fund Directive of October 2000, the European Commission issued its "Communication on the elimination of tax obstacles to the cross-border provision of occupational pensions" in April 2001. In the Communication the Commission concluded that the above discrimination of foreign pension funds is contrary to the EC Treaty and announced that, where necessary, it would begin legal proceedings before the European Court of Justice in Luxembourg (ECJ).

The Commission pursued no less than nine infringement procedures against the old Member States, namely Belgium, Denmark, Spain, France, Ireland, Italy, Portugal, Sweden and the United Kingdom. At this moment the results are the following: Portugal and Ireland have changed their laws, and now also allow tax deduction for pension contributions paid to foreign IORPs. The infringement procedures against them are closed. The UK has changed its law, the new rules will enter into force as of April 2006. Belgium and Spain agreed to change their law, but have not done so yet. The Commission referred them to the ECJ. Somewhat later France also agreed to make the necessary changes, although they have still not been published. Italy has not yet agreed to change its law, and was referred to the ECJ on 5 July 2005. Denmark disagrees on the principles, and had already been referred to the ECJ earlier. The procedure against Sweden continues.

Germany, The Netherlands and Austria had previously allowed deductions of contributions paid to foreign pension funds. Finland had been the subject of a ruling by the ECJ following a request for a preliminary ruling by a local judge, and changed its law after it lost its case. Luxembourg is the only old Member State where pension contributions are not tax deductible, so there was no discrimination issue there. The situation in Greece is not entirely clear, although the European Commission has not announced the opening of an infringement procedure against Greece.

'At present there is no tax obstacle for pension contributions paid to foreign IORPs from Germany, Ireland, Luxembourg, The Netherlands, Austria, Portugal and Finland. Soon this will also be the case for contributions from Belgium, Spain, France and the United Kingdom.'

To summarize the above: at present there is no tax obstacle for pension contributions paid to foreign IORPs from Germany, Ireland, Luxembourg, The Netherlands, Austria, Portugal and Finland. Soon this will also be the case for contributions from Belgium, Spain, France and the United Kingdom. Denmark will be the subject of the next ruling of the ECJ on this issue. It may find it very difficult to explain to the ECJ why allowing cross-border deduction would ruin its pension taxation system, while so many other Member States have already shown that they could do it without any major difficulties. Italy and Sweden may still cross the bridge. Only Greece is unclear. The Commission is expected to start to examine the situation in the ten new Member States this year.

The second main tax obstacle for IORPs is the taxation of the transfer of pension capital. Once an IORP is established the need arises to transfer the pension capital accumulated in the old local funds to the new IORP. Taxation of such transfers is prohibitive. The Commission's Pension Taxation Communication of April 2001 already highlighted the transferability issue and concluded that there might be infringements of the EC Treaty, especially if Member States taxed cross-border transfers while domestic transfers were exempt. The Communication also indicated that the Commission would open infringement procedures where necessary. However, when following up its Communication, the Commission gave priority to the issue of cross-border deductions. Only in the case of Belgium did it attack the taxation of the cross-border transfer, and Belgium has announced that its new law will exempt cross-border transfers on the same conditions as domestic transfers.

It now seems that the EFRP will come to the help of the Commission. The EFRP has launched a major enquiry into all twenty five Member States' national tax rules on pension capital transfers. It presented its preliminary findings to Commissioner Kovacs, the European Commissioner responsible for taxation, on 27 April 2005. At the same time the EFRP announced that it would launch formal complaints with the Commission wherever it found that national rules on the transfer of pension capital were incompatible with the EC Treaty.

The main conclusions of its enquiry were that in a number of Member States transfers of pension capital between domestic funds are tax-free, whereas transfers to foreign funds are taxed. It also found that some Member States allowed tax-free domestic transfers but prohibited cross-border transfers altogether. It may well be that the latter restriction is

also against the EC Treaty, especially against the principle of the free movement of capital, and, in case the employee moves too, also the free movement of workers. Another finding of the study was that some Member States allow tax-free cross-border transfers. This will make it difficult for Member States not allowing tax-free transfers to explain to the ECJ that their pension taxation systems would collapse if they were forced to allow them. A positive finding was that some of the Member States which currently tax cross-border transfers have planned to make these tax-free, in the framework of their implementation of the Pension Fund Directive.

'Some Member State even tax inbound transfers.'

The last finding was quite surprising: some Member State even tax inbound transfers. The EFRP noted that if capital is transferred from a Member State which taxes outbound transfers to a Member State which taxes inbound transfers there is very little left of the capital.

In conclusion: Cross-border tax deduction is no longer an issue for IORPs in most of the old Member States. The Commission is expected to commence its examination of the ten new Member States later this year. The restrictions to the cross-border transfer of pension capital are still an issue for IORPs, but hope is shining on the horizon. Many of the restrictions identified by the EFRP may not be compatible with the EC Treaty. Once the Commission receives the formal complaints it has one year to decide whether to open an infringement procedure or not, according to its internal rules. It will require some hard legal work, but it may well be that within a few years from now the restrictions to the cross-border transfer of pension capital will be eliminated.

Peter Schonewille works in the unit dealing with direct tax infringement cases at the Directorate-General Taxation and Customs Union of the European Commission in Brussels. His article is written on a personal basis and does not necessarily reflect the opinion of the European Commission.