Euro Tax Flash from KPMG's EU Tax Centre

CJEU rules that the Polish tax exemption limited to externally managed investment funds breaches EU law

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On February 27, 2025, the Court of Justice of the European Union (CJEU or the Court) gave its decision in case C-18/23. The case examined whether a Polish tax exemption, granted only to externally managed non-resident investment funds, is compatible with the free movement of capital under EU law.

Contrary to the opinion of Advocate General (AG) Kokott, the Court concluded that the Polish legislation under dispute is contrary to the free movement of capital.

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Background

Under Polish rules, all domestic funds set up under Polish Law on investment funds are exempt for corporate income tax purposes. In addition, subject to certain conditions, the Polish Tax Code provides for a tax exemption with respect to Polish-generated income to open ended funds (UCITS) as well as other non-UCITS types of investment funds, including specialized funds and closed-ended funds, domiciled in an EU or EEA jurisdiction. One of the conditions is that the fund must be managed by entities authorized by the competent financial market supervisory authorities of the state where the managing entity is based (i.e., externally managed). It should be noted that, under Polish law, the establishment of internally managed investment funds is not permitted.

The plaintiff was a specialized investment fund incorporated in Luxembourg and authorized by the Financial Sector Supervisory Commission in Luxembourg. The Fund was managed by its board of directors (i.e., internally managed). The board of directors was authorized by the competent Luxembourg supervisory authority, was registered as an alternative investment fund manager, and was also included in the list of managers.

The plaintiff applied for an advance tax ruling from the Director of the National Tax Information Office in Poland, claiming that the income generated in Poland should benefit from the exemption mentioned above. The Polish tax authorities refused to issue the advance tax ruling, arguing that only externally managed investment funds could benefit from the tax exemption, and that the plaintiff's management did not meet this requirement. Following legal proceedings initiated by the plaintiff, the Regional Administrative Court expressed doubts about the compatibility of the Polish law with the EU fundamental freedoms and referred the case to the CJEU.

On July 11, 2024, AG Kokott recommended that the CJEU finds the Polish tax exemption for externally managed investment funds compatible with EU law arguing that there is no restriction of the free movement of capital. The AG ruled out the existence of direct discrimination, as the tax exemption under dispute applies regardless of the domicile of the investment fund. The AG also concluded that the rules at hand do not result in indirect discrimination, citing, amongst other reasons, the lack of discriminatory effect of the criterion of differentiation chosen by Poland and the autonomy of Member States in taxing investment funds.

The AG also explored an alternative line of reasoning whereby the CJEU finds that the disputed measure does lead to indirect discrimination of internally managed funds. Under this scenario, the AG argued that investment funds set up in Poland and internally managed investment funds set up abroad are not in an objectively comparable situation. The AG reached this conclusion on the ground that the rules aim to protect investors, and – in the AG's view, only externally managed investment funds can adequately ensure the separation of investment assets from the management company's assets.

In a third line of reasoning, assuming the CJEU considers the two types of investment funds to be in an objectively comparable situation, the AG held that the difference in treatment could be justified by an overriding reason in the public interest, i.e., effective investor protection, and that the measure would be proportionate. For more details on the AG opinion, please refer to E-News Issue 199.

The CJEU Decision

Potential restriction on the free movement of capital

The Court recalled that a different treatment of resident and non-resident funds could be permitted under the free movement of capital if it relates to situations that are not objectively comparable or where the restriction can be justified by an overriding reason relating to the public interest.

The CJEU noted that the disputed rules do not represent direct discrimination, as the tax exemption was not denied based on the residence of the fund, but on the basis of its management form. However, the rules could still *de facto* place cross-border situations at a disadvantage (indirect discrimination). The CJEU recalled its settled case-law according to which indirect discrimination may occur when the tax advantage is linked to conditions or obligations specific to the national market, in such a way that only resident operators are able to meet them, whilst comparable non-resident operators cannot generally comply with such requirements.

Since EU law in this area is not harmonised, the Court acknowledged that Member States remain free to determine the management form applicable to investment funds set up within their territory and are also free to define the material and formal conditions which must be respected by funds to benefit from specific tax regimes. However, the Court noted that a Member State cannot impose conditions denying income tax advantages on investments made in that Member State by non-resident investment funds, which have adopted a management form authorized by the legislation of their home Member State and which operate in accordance with that legislation, solely on the ground that their management form does not correspond to the management form required for resident investment funds.

In light of the above, the CJEU therefore found that the Polish legislation leads to a restriction that is liable to deter non-resident investment funds from making Polish investments. The disputed Polish legislation therefore breaches the free movement of capital.

Comparability of the cross-border situation with the internal situation

As regards the comparability analysis, the CJEU reiterated its settled case law according to which the comparability of a cross-border situation with a domestic situation should be assessed based on the objective pursued by the national legislation at stake and the purpose and content of the relevant provisions. Furthermore, only the relevant distinguishing criteria included in the national legislation should be taken into account when assessing whether there is a different tax treatment related to a situation that is objectively comparable.

The CJEU noted that the referring court did not describe the objective pursed by the Polish tax exemption granted to funds managed externally and that it is up to the referring court to interpret such objective. Under the assumption that the referring court would find that the exemption is intended to avoid double taxation of income (both at the investment fund level and at the investor level), such an objective may be achieved irrespective of the management form of the investment vehicle. Therefore, this would not place internally management funds in a different situation from externally managed funds. Furthermore, whilst the different levels of investment risk associated with funds managed externally or internally could explain the design of local requirements for setting-up an investment fund in Poland, in the Court's view such considerations are not capable of demonstrating differences in their situation with respect to the corporation tax exemption.

In light of the above, the CJEU held that externally managed investment funds domiciled in Poland and internally managed investment funds domiciled abroad are in an objectively comparable situation.

Potential overriding reason in the public interest

Lastly, the Court rejected both justifications put forward by the Polish government, namely:

- *The protection of investors*. The Polish government had argued that the condition related to the external management form is intended to protect the interests of investors. In the Polish's government view, the conditions seek to separate the capital of investors grouped together in the investment fund from the assets of the management company and thus, to separate investment risks from those associated with the creation and the management of the investment fund. The CJEU recalled its settled case-law according to which the protection of investors may, in principle, constitute an overriding reason in the public interest, capable of justifying a restriction on the free movement of capital. The Court then noted that the disputed Polish tax exemption includes additional conditions that already ensure that activity of non-resident funds is supervised by the financial market supervisory authorities of their home country. Furthermore, the CJEU noted that the Polish government failed to explain how granting the exemption to internally managed funds would jeopardize the objective of protecting investors. Moreover, in the Court's view, whilst favorable tax treatment for externally managed funds could encourage their use, offering less favorable treatment to internally managed funds does not automatically protect investors. Therefore, the CJEU concluded that such a tax measure is not suitable for achieving the objective of investor protection[1], particularly when the foreign funds are supervised by the financial authorities of their home country.

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[1] Under settled CJEU case-law, once a discriminatory measure has been classified as justified by an overriding reason in the general interest, the next step is to assess whether the measure is proportionate, that is: (i) it does not go beyond what is necessary to achieve its objectives (i.e. it is the least restrictive measure available for the purposes of the tax measure / tax regime), and (ii) it is appropriate to ensuring the achievement of that objective.

- *The prevention of abuse*. The Court noted that the Polish government failed to explain and establish a link between the management form of an investment fund and a possible risk of abuse.

The Court's decision

In the light of all the foregoing considerations, the CJEU ruled that Article 63(1) of the Treaty on the Functioning of the European Union establishing the EU free movement of capital precludes legislation of a Member State which grants a corporate tax exemption only to externally managed funds and denies the exemption to internally managed funds that are constituted in accordance with the legislation of another Member State.

ETC Comment:

The CJEU's judgment is significant for the Polish market and should enable internally managed foreign investment funds to reclaim withholding tax collected on income received from their Polish investments, provided all other relevant conditions are met.

Note that it may now be possible to reopen previously closed cases, provided, among others that a formal request is submitted based on the CJEU's ruling in this case. The request must be filed with tax authorities within one month as from the date of the CJEU's decision or with the administrative courts within three months from that date. The possibility of reopening closed cases should be assessed on a case-by-case basis, in light of applicable domestic regulations.

Should you have any queries, please do not hesitate to contact KPMG's EU Tax Centre, KPMG in Poland (Michal Niznik) or, as appropriate, your local KPMG tax advisor.

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