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ECJ CASES

Finland – A-G Opinion in the Oy AA case (*C-231/05*)**: Finnish group contribution rules**

On 12 September 2006, A-G Kokott opined that Finland does not infringe Article 43 EC (freedom of establishment) by precluding foreign group companies from the group contribution facility.

Finnish resident company Oy AA contemplated giving a group contribution to its great-grand-parent company AA Ltd. resident in the UK. According to the Finnish Group Contribution Act (GCA) a group contribution is tax deductible for the distributor and taxable for the recipient, thus, in a case of tax losses, these losses may be utilized within a group by a means of group contribution. One of the requirements for a tax deductible contribution is that both the payer and the recipient must be residents of Finland.

The A-G first considered the issue primarily with respect to Article 43 EC instead of Article 56 EC (free movement of capital). The A-G opined that international groups were treated less favourably than domestic groups, and that such treatment is in breach of Article 43. The A-G rejected the argument of non-comparability based on different tax jurisdictions.

When considering possible justifications, the A-G accepted the so-called *Marks & Spencer* justification (*C-446/03*;): the preservation of allocation of taxing power between Member States, the prevention of double relief and the risk of tax avoidance taken together, which allow Finland generally to deny cross-border group contribution. The A-G subsequently opined that these measures, especially with respect to the allocation of taxing powers, were proportionate. The facts of the case did not include so-called *Marks & Spencer* losses (i.e. losses without the possibility to offset them). See also EUDTG Newsalert NA 2006 – 23.

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Germany – Referral to ECJ regarding deduction of EU branch losses: M+T case (*C-414/06*)

On 28 June 2006, the Federal Tax Court referred a question to the ECJ on whether Article 43 EC (freedom of establishment) and Article 56 (free movement of capital) preclude German provisions which deny the deduction of foreign branch losses based on the fact that the corresponding branch profits would be tax-exempt under a double tax convention.

M+T, a German partnership, applied for the immediate deduction in Germany of a loss from a Luxembourg branch in 1999. The double tax convention between Luxembourg and Germany exempts income from a Luxembourg branch from German taxation. According to established case law of the Federal Tax Court, in this context "income" is understood as "net income" so that the exemption refers to profits and losses (so-called "principle of symmetry"). Until 1998, German law contained a provision according to which such tax-exempt branch losses were allowed for deduction nonetheless. This beneficial treaty override was accompanied by a recapture rule by which future branch profits could be taxed despite the double tax convention to the extent branch losses had been deducted before. Having been abolished since 1999, M+T could not claim this beneficial treaty override for the 1999 losses and was thus denied their immediate deduction in Germany.

In the referral decision, the Federal Tax Court reconfirms the principle of symmetry and rejects following opposing case law in Austria (2001) and Luxembourg (2005). On the unequal treatment of foreign and domestic branch losses - the latter being immediately deductible without restriction - the Court raises the question whether at least the denial of *immediate* deduction for foreign branch losses could be defended by the *Marks & Spencer* justification (*C-446/03):* the preservation of allocation of taxing powers between Member States, the prevention of double relief and the risk of tax avoidance taken together. Acknowledging that the last of these three arguments could hardly be valid in the case of a branch, the Court desires further clarification by the ECJ as to whether each of these three arguments has the same weight and thus has to be fulfilled or whether these three arguments are to be considered only in an overall evaluation of the case. The Court further raises the question, whether an immediate loss deduction combined with a recapture in case of future branch profits, as applied in Germany until 1998, could represent - at least in the case of branch losses - a more appropriate measure than limiting the deduction to definite losses.

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Germany – Referral to ECJ regarding deduction of Third State branch losses: Stahlwerk Ergste Westig case (*C-415/06*)

On 22 August 2006, the Federal Tax Court referred to the ECJ the question whether Article 56 EC (free movement of capital) precludes German provisions denying the deduction of foreign branch losses from a Third State (here: the US) based on the fact that the corresponding branch profits would be tax-exempt under a double tax convention. In the context of an infringement which has been confirmed in principle by the ECJ, the Court further asked whether it could be permissible nonetheless based on the "stand-still clause" of Article 57 EC.

Stahlwerk Ergste Westig, a German company, applied for the immediate deduction in Germany of a loss from a US partnership (treated like a branch loss) in 1999. The double tax convention between the US and Germany exempts income from a US branch from German taxation. For the same reasons and based on the same set of provisions as in the M+T case (see above), Stahlwerk Ergste

Westig was denied this deduction of "tax-exempt" losses according to the German "principle of symmetry".

As regards the material questions related to the deduction of "tax-exempt" losses, the Federal Tax Court mainly refers to its referral decision in the M+T case (see above), so that this referral focuses on the specific questions related to the fact that the branch is situated in a Third State. The only fundamental freedom explicitly protecting transactions with Third States is the free movement of capital. According to the stand-still rule in Article 57 para 1, restrictions of the free movement of capital existing on 31 December 1993 are allowed, however, to be upheld regarding Third States.

The Federal Tax Court seeks, as a first step, clarification with regard to the stand-still clause. On the one hand, the restricting measure, here the double tax convention between the US and Germany, had been in force for years on 31 December 1993. On the other hand, this restriction was effectively suspended until 1998 by the beneficial treaty override in German domestic law, according to which tax-exempt branch losses were able to be immediately deducted for the price of a future recapture. Thus the restriction imposed by the double tax convention might be viewed as effective from 1999 only.

As regards the scope of the free movement of capital as such in the case of Third State transactions, the Court raises the question whether a limitation of this scope might be justified and not constitute impermissible arbitrary discrimination. The Court doubts that the risk of substantial budgetary consequences for the Member States is automatically disqualified as a justification ground in cases involving Third States. Secondly, the risk of double utilization of the branch losses might be attributed a different weight in Third State cases taking into account the reduced means of effective control by the Member States.

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Germany – ECJ judgement in the Stauffer case (*C-386/04*)**: charitable foundations**

On 14 September 2006, the ECJ ruled that Article 56 (free movement of capital) precludes a Member State from refusing to grant a tax exemption to a non-resident charitable foundation solely on the grounds that the foundation is not a resident State

Centro di Musicologia Stauffer (Stauffer) is an Italian resident charitable foundation. According to the referring German Federal Tax Court, the foundation pursued charitable purposes according to the criteria in German tax law, which does not require the promotion of the interests of the general public to be undertaken for the benefit of German nationals. The foundation's only link to Germany was its German real estate from which it derived rental income. The rental income was subject to German corporate income tax, since the tax exemption from corporate income tax for charitable foundations requires their tax residence in Germany.

The ECJ affirmed that the limitation of the tax exemption to German resident charitable foundations places charitable foundations in other Members States at a disadvantage and constitutes an obstacle to the free movement of capital.

All justification arguments brought forward were rejected by the ECJ. In particular, the ECJ found Stauffer and a German resident charitable foundation to be in a comparable situation, since Stauffer fulfilled all the requirements for a tax exemption apart from its residence in Germany. The ECJ emphasized that EC Law does not require Member States to automatically acknowledge the foreign charitable status of foundations in their own territory. They are free to determine what interests they wish to promote. However, where a charitable foundation of one Member State satisfies the requirements of another Member State, the authorities cannot deny the right on equal treatment/granting of the tax exemption solely on the ground of non-residency in that Member State. See also EUDTG Newsalert NA 2006 – 25.

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Germany – A-G Opinion in the Schwarz/Gootjes-Schwarz (*C-76/05*) and Commission v Germany (*C-318/05*): tax deduction for school fees

On 21 September 2006, A-G Stix-Hackl opined that the non-deductibility of fees for foreign schools is in conflict with Article 49 EC (freedom to provide services), since the tax deductibility is dependent on the school's residence in Germany.

The case was brought to the ECJ by the Tax Court of Cologne. The claimants who live in Germany have two daughters attending an International School in Scotland. This school charges annual fees of a considerable amount. Under the German Income Tax Act, 30 % of the fees paid to certain schools may be deducted from the income tax base as special expenses, provided that the schools concerned are recognised as providing public education according to the German Constitution or to German State law. Fees paid to a foreign school cannot be deducted, since foreign schools are not subject to the German jurisdiction, The Tax Court therefore requested a preliminary ruling on whether or not this non deductibility is in conflict with one or more of the fundamental freedoms under the EC Treaty. The A-G's Opinion in this case and the infringement proceeding by the Commission against Germany on the same subject were combined by the ECJ.

Concerning the freedom to provide services (the freedom applicable in this case), the A-G first pointed out that according to previous ECJ case law, the provision of education can be characterised as a service in the meaning of Article 49 EC, if the educational institution is capitalised primarily by private resources and aims at making a profit. It is not relevant that the provision of education is a public duty in Germany for which, as a general rule, no cost-effective fees are charged: The ECJ has in a recent ruling stated that as long as the service is provided in one Member State in a profit-oriented way, the freedom to provide services according to Article 49 will be applicable (*Watts*, *C-372/04*). Even though German schools generally operate without the aim to make a profit, there are exceptions, so that in certain circumstances they do provide services in the sense of Article 49. Consequently, the A-G considered the non-deductibility of fees for foreign schools as an unjustifiable discrimination, since the tax deductibility is dependent on the school's residence in Germany. See also EUDTG Newsalert NA 2006 – 26.

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Germany – Second A-G Opinion in Meilicke case (*C-292/04*): limitation of the temporal effects of ECJ judgments

On 5 October 2006, A-G Stix-Hackl opined not to limit the temporal effects of the Meilicke judgment.

In the Meilicke case, German individuals have claimed for an imputation credit on dividends received from Danish and Dutch companies in 1995 up to and including 1997. Such imputation credit was granted - under the old German imputation system - only for dividends from German resident companies to shareholders subject to unlimited tax liability in Germany.

With reference to the *Manninen* decision *(C-319/02)*, A-G Tizzano concluded in the first Opinion (See also EUDTG Newsalert NA 2006 – 13) that the limitation of an imputation credit to dividends from domestic companies should be considered exclusively as an unjustifiable breach of the freedom of free movement of capital. In view of possible serious economic repercussions due to estimated tax refunds up to € 5 billion and a possible legal uncertainty regarding the implications of EC Law for the German imputation system at least until the *Verkooijen* decision in 2000 *(C-35/98),* A-G Tizzano suggested that the prerequisites for restricting the temporal effects of the Meilicke Judgement to have been met. His colleague, A-G Stix-Hackl, has now put a second Opinion with regard to the temporal limitation of the case before the ECJ.

Despite the fact that the ECJ had already interpreted the applicable EC Law provisions in the *Manninen* and *Verkooijen* cases without restricting the temporal effects of those decisions, the A-G did not reject Germany's application for limiting the temporal effects of the Meilicke decision. The A-G admitted that the complexity of each national tax law often makes it difficult for the Member States to anticipate the impact of a decision on their own tax law.

With regard to the two prerequisites for a limitation of the judgement's temporal effects, the A-G was not convinced that the German Government had been uncertain about the EC Law implications for the German imputation system. Germany had initiated the abolition of the imputation system already before the *Verkooijen* judgement stating in the preparatory law documents that the system had not been in accordance with EC Law. She argued further, that the silence of the Commission with regard to certain behaviour of a Member State cannot be understood as an approval of that behaviour. Finally, the A-G emphasized that the German Government had failed to substantiate (i) the risk of serious economic repercussions, as this risk cannot be evidenced by presenting the pure financial consequences, and (ii) the actual financial risk based on the number of cases filed. See also EUDTG Newsalert NA 2006 – 30.

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Germany – ECJ judgment in the Fidium Finanz case (*C-452/04*)**: the granting of credits by credit institutions is primarily covered by Article 49 EC**

On 3 October 2006, the ECJ judged that the granting of credits by credit institutions is primarily covered by Article 49 EC (freedom to provide services). Therefore, Fidium Finanz, resident of a third country, cannot rely upon Article 56 EC (free movement of capital) to get access to the German market.

Fidium Finanz (Fidium) is a Swiss company that offers small scale credits to foreign customers. Approximately 90 % of the credits are granted to German residents. The credits are offered by an Internet site run from Switzerland. As Fidium refused to obtain an authorisation in Germany, the German authorities prohibited Fidium from carrying on its activities in Germany. Fidium thereupon claimed that this is an infringement of the free movement of capital and took the case to court.

The Administrative Court of Frankfurt decided to stay the proceedings and refer the case to the ECJ. The Court firstly asked the ECJ whether an undertaking having its registered office in a non-EU Member State (here: Switzerland) can rely on the free movement of capital (Article 56 EC) in respect of the granting of credit to residents of an EU Member State (here: Germany), or whether such financial services are solely covered by the freedom to provide services (Article 49 EC)?

The ECJ considered that a company established in a non-EU Member State cannot rely on the freedom to provide services, as this is - contrary to the free movement of capital - not applicable to services providers in non-EU Member States.

Based on settled EC case law, the ECJ then held that the activity of granting credits on a commercial basis in principle falls both under the freedom to provide services and the free movement of capital. It is therefore necessary to consider if and to what extent the disputed rules might be capable of hindering the exercise of these freedoms.

The disputed rules aim at supervising the provision of banking and financial services and to authorise provision only for undertakings which guarantee to conduct the transactions properly and thereby prevent economic operators without the qualities required by German law from accessing the German market. This prevention restricts the freedom to provide services, as it impedes or renders less attractive the exercise of that freedom. However, as Fidium is established in a non-EU Member State, it cannot rely on this freedom.

Although the free movement of capital may be restricted by the German rules, the ECJ stated that this is merely an unavoidable consequence of the restriction of the freedom to provide services and that this freedom is the predominant consideration in the present case.
See also EUDTG Newsalert NA 2006 – 29.

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Germany – ECJ judgment in the case FKP Scorpio Konzertproduktionen GmbH (*C-290/04*)**: German tax at source on certain income for non-residents**

On 3 October 2006, the ECJ judged that the German tax at source on certain income for non-residents and the liability for taxes not-withheld are not in breach of Article 49 EC (freedom to provide services).

Non-residents are subject to German tax e.g. for German royalty income and income derived through artistic and sports performances in Germany. The tax is deducted at source on the gross amount in a range from 0 to 20 %, without deductions for expenses. The debtor is liable for the withholding. Even if a tax treaty provides for a lower or no German tax at all, the tax must be withheld and is subsequently refunded, unless an exemption certificate is issued in advance by the tax authorities. There is no withholding and no liability for payments to resident creditors. Resident creditors are subject to tax on their net income with the regular tax rate (for individuals at that time, the highest progressive tax rate was 53 % on net income).

Scorpio, a German resident, arranged concerts in Germany and made payments to a Dutch resident individual for providing artistic performances in 1993, without withholding tax from the payments. The Dutch resident had not produced an exemption certificate. The tax authorities held Scorpio liable for the withholding tax, amounting to 15 % of the remuneration. (See also EUDTG Newsalert NA 2006 – 13).

The ECJ stated that the obligation to withhold tax only on payments to non-resident creditors and the liability for the tax along with this, may deter companies such as Scorpio from calling on non-residents to provide services and that this basically constitutes an obstacle to the freedom to provide services (Article 49 EC). However, the obstacle is justified due to the necessity to secure the taxation of non-residents and to make sure that the income does not remain completely untaxed. The ECJ pointed out that in the year in question (1993), neither EC Law nor the Dutch / German tax treaty provided means for Germany to recover taxes in the Netherlands. Moreover, the withholding procedure is a proportionate means of ensuring the recovery of tax. This accordingly applies to the liability for taxes not-withheld.

The ECJ established that having to subsequently claim deduction of expenses that are directly economically linked to the German income instead of deducting these immediately, constitutes an unjustifiable obstacle to Article 49 EC. In respect of other expenses i.e. those which do not have a direct link to the income, the ECJ stated that due to lack of information on its part, the ECJ could not carry out any comparison between resident and non-resident service providers. The freedom to provide services does not preclude that other expenses than expenses directly linked to the income (in the sense of the *Gerritse* decision *(C-234/01)*) are subsequently taken into account in a refund procedure.

The requirement of an exemption certificate in order to benefit from a tax treaty zero rate in Germany is an infringement which is justified by the necessity to ensure the proper functioning of source taxation.

Finally, the ECJ noted that the service recipient (*Scorpio*) is protected by Art 49 EC even though neither he nor the service provider moves within the EU. See also EUDTG Newsalert NA 2006 – 28.

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Italy – ECJ judgment in the Banca Popolare di Cremona v. Agenzia delle Entrate (*C-475/03*) case: IRAP is compatible with EU Sixth VAT Directive

On 3 October 2006, the ECJ decided that IRAP is compatible with EU VAT legislation.

IRAP is an Italian tax levied on companies, partnerships and individuals, introduced in Italy in 1998. The ordinary tax rate is equal to 4.25%. IRAP is levied on an amount calculated by deducting production costs from the sales value but excluding principally labour costs.

In 1999, Banca Popolare di Cremona requested a reimbursement from the Italian Tax Authorities of the IRAP paid, arguing that the tax was unlawful, because it was contrary to EU VAT legislation (Article 33 of the Sixth VAT Directive prohibits EU Member States from introducing “any taxes, duties or charges which can be characterised as turnover taxes”). After the reimbursement denial from the Italian Tax Authorities, the Cremona Tax Court referred the case to the ECJ.

The two A-Gs (Jacobs and Stix-Hackl) agreed upon the incompatibility of IRAP with the Sixth VAT Directive because, in their Opinions (delivered on 17 March 2005 and 14 March 2006 respectively), they concluded that the Italian tax displays all four essential features of VAT:

- it applies generally to supplies of goods or services;
- it is proportional to the price of those goods or services, whatever the number of transactions carried out;
- it is charged at each stage of the production and distribution process; and
- it is imposed on the value added of the goods and/or services in question and the final burden of the tax rests ultimately on the consumer.

Challenging the opinions of the A-Gs, the ECJ stated that IRAP did not meet two of the four essential features of VAT.

The ECJ first pointed out that any comparison of the characteristics of a tax such as IRAP with those of VAT must be made in the light of the objective pursued by the common system of VAT (of harmonisation of legislation concerning turnover taxes in order to establish a common market). In particular, the ECJ observed with reference to the second essential characteristic that whereas VAT is levied on individual transactions at the marketing stage and its amount is proportionate to the price of goods or services supplied, IRAP is, in contrast, a tax charged on the net value of the production of an undertaking in a given period.

Referring to the fourth essential characteristic, the ECJ stated that a tax such as IRAP levied on production in such a way that it is not certain that it will be borne by the final consumer (like a tax on consumption such as VAT) is likely to fall outside the scope of Article 33 of the Sixth VAT Directive See also EUDTG Newsalert NA 2006 – 27.

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Italy – ECJ Order in the Banca Popolare FriulAdria S.p.A. v. Agenzia delle Entrate (*C-336/04*) **case: State aid to Italian banks for merger transactions**

Banca Popolare FriulAdria S.p.A. is an Italian bank which during 1999 and 2000 utilised a tax regime encouraging the restructuring of the Italian banking system by way of mergers between banks and other similar acquisitions.

The tax relief, introduced by the Italian Law 461/1998, mainly consisted of the reduction of the income tax (IRPEG) rate from 37/36% to 12.50% for the banks that execute a merger or a similar restructuring transaction and potentially constituted State aid incompatible with the EC Treaty.

On 14 September 2006, the ECJ issued an Order affirming that the preliminary questions relevant to case C-336/04 on the incompatibility of the tax relief with the EC Treaty were identical to the questions in case C-148/04 and that they were connected to the questions in case C-66/02 (both cases were decided by the ECJ on 15 December 2005; see EUDTG Newsletter NA 2005 – 006).

Consequently, the ECJ, confirming its previous judgments, opined that the Italian Law 461/1998 constitutes a State aid and that it therefore is incompatible with the EC Treaty.

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Italy – A-G opinion in the AEM S.p.A. case (*C-463/04* and *C-464/04*)**: Italy's "golden shares" rules**

On 7 September 2006, A-G Maduro opined that Italy's "golden share" rules are in conflict with Article 56 EC (free movement of capital).

AEM S.p.A. (AEM) is an Italian joint-stock company operating in the field of distribution of gas and electricity. In 2004, the Municipality of Milan decided to transfer part of its shares in the company to private investors, switching from an absolute majority (51%) to a relative majority (33.4%), and it amended the By-laws of the company with reference to the appointment of directors.

The Municipality of Milan reserved the right to directly appoint two directors (based on Article 2449 of the Italian Civil Code) and applied the "*voto di lista*" mechanism (based on the Law Decree 332/1994) for the appointment of the remaining part of the Board of Directors. The combination of direct appointment powers and "*voto di lista*" allowed the Municipality to appoint the majority of the company's directors even though it did not own the absolute majority of the share capital of AEM.

The A-G concluded that national rules which enable a public body holding a minority shareholding (33.4%) in a privatised company to appoint an absolute majority of the members of the Board of Directors, constitutes a restriction of the movement of capital for the purposes Article 56 EC.

In particular, in the A-G's Opinion, the fact that the powers of appointment of the Municipality of Milan are based on a provision of private law (the Company By-law) does not preclude the application of Article 56 EC. Furthermore, the A-G observed that the provisions of Article 56 EC apply to a public body, where its actions, regardless of their legal form, are private in nature and thus are not carried out in the exercise of the public authority of the State. Finally, the A-G pointed out that rules of national law, from which only the State and public bodies can derive special powers, amount to a restriction of the movement of capital for the purposes of Article 56 EC.

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Netherlands – ECJ judgment in the N case (*C-470/04*)**: Dutch exit tax is disproportionate**

On 22 January 1997, Mr. N (N) transferred his residence from the Netherlands to the UK. At the time he left the Netherlands, N held 100% of the shares in three Dutch BVs (limited liability companies). The management of these BVs has since that same date been in the Netherlands Antilles. Due to his emigration and pursuant to Dutch income tax law, N had deemed disposed of his shares; consequently Dutch income tax was levied with regard to the difference between the market value and the acquisition price of the respective shareholdings. At his request, N obtained a deferment of tax payment for a period of ten years, which deferment was made subject to the provision of a security. N objected to both the fact that the Netherlands levied taxes upon emigration with regard to his substantial shareholdings and the obligation to provide security in order to obtain deferment of payment of taxes. He considered both measures in breach of EC Law.

On 7 September 2006, the ECJ ruled that the Dutch exit tax with regard to substantial interest shareholdings is in breach of Article 43 EC. As such, the ECJ ruled in favour of N by confirming that Article 43 EC applies to the situation of an EU Member State national who, since the transfer of his residence, has been living in one Member State while holding all the shares of companies established in another Member State.

The ECJ observed that a taxpayer wishing to transfer his residence outside The Netherlands was subjected at the time of the facts to disadvantageous treatment in comparison with a person who kept his residence in The Netherlands. After all, the increases in value of shareholdings would only be taxed when and to the extent that they were actually realised. This different treatment is likely to discourage the person concerned from transferring his residence outside The Netherlands. More specifically, the emigrant is confronted with the following three disadvantages:

- he cannot obtain an automatic and unconditional suspension of payment of taxes;
- the tax declaration required at the time of transferring residence outside the Netherlands;
- decreases in value occurring after the transfer of residence were not taken into account in order to reduce the tax debt at the time of the facts in the main proceedings.

In summary, the ECJ considered that the Dutch tax system is likely to hinder the exercise of the freedom of establishment.

However, the legislation at issue pursues an objective which is in the public interest and it is appropriate for ensuring the attainment of that objective, namely the allocation between Member States of the power to tax increases of value in substantial shareholdings on the basis of the territoriality principle. The measures at issue however do not stand the *rule of reason* test, since they go beyond what is necessary to attain the objective pursued. Firstly, the obligation to provide guarantees necessary for obtaining a deferral of the tax normally due is disproportionate given the existing Council Directives on Mutual Assistance. Secondly, in order to be proportionate to the objective pursued, a system for recovering tax on the income from securities would have to take full account of reductions in the value capable of arising after the transfer of residence by the taxpayer concerned, unless such reductions have already been taken into account in the host Member State. See also EUDTG Newsalert NA 2006 – 21.

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Portugal – Portugal v the Commission (*C-88/03*)**: State aid in the Azores**

On 6 September 2006, the ECJ classified as State aid the reduction of personal and corporate income tax rates for entities resident in the Portuguese Autonomous Region of the Azores.

The Portuguese Republic brought an action before the ECJ seeking the annulment of the Commission’s Decision of 11 December 2002 (2003/442/EC), which classifies as State aid the reduction of personal and corporate income tax rates for entities resident in the Autonomous Region of the Azores. The outcome of a formal investigation by Portugal, which followed the Commission’s Guidelines on Regional Aid, was that the aid in question was considered to be compatible with the EU rules by means of a derogation laid down in Article 87(3) a and c of the EC Treaty, which state that aid can be allowed if used to promote the economic development of areas where the standard of living is abnormally low, where there is serious underemployment or to facilitate the development of certain economic activities in such areas, as far as the aid is intended to offset the additional costs arising from the factors as identified in Article 299 (2) of the EC Treaty (for instance: remoteness, insularity and economic dependency on a few products).

However, in the Commission’s view, the derogation should not apply to the financial sector and “intra-group services” activities (section K, Code 74 of NACE Rev. 1.1). The Commission ordered Portugal therefore to recover the aid granted to entities carrying on financial or intra-group service activities.

The ECJ decided that a geographically limited national tax rate variation is not selective if the lower tax results from a decision taken by a local authority that is truly (institutionally, procedurally and economically) autonomous from the central government of a Member State. Although The Azores are an autonomous region under the Portuguese Constitution with its own governmental bodies with the power to exercise their own fiscal competence and right to adapt national fiscal provisions to regional specificities, the decision of the Azores Regional Assembly to allow the contested tax reduction was not made truly autonomously, as the reduction in tax revenue is offset by a financing mechanism which is managed on a Portuguese level. See also EUDTG Newsalert NA 2006 – 24.

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Portugal – Referral to ECJ of tax treatment of capital gains

The Supreme Administrative Court referred a question to the ECJ concerning Portuguese legislation applicable to the taxation of capital gains. According to Article 43 (2) of the Personal Income Tax Code, a 50% reduction applies, among others, to the taxation of capital gains realized by residents concerning the transfer of immovable property (rights) and the disposal in contracts or rights related to immovable property. No such reduction of the taxable base applies to capital gains realized by non-residents, including residents of other Member States. As the Supreme Administrative Court considered that this rule may constitute an infringement of Articles 12, 18, 39, 43 and 56 of the EC Treaty regarding the free movement of persons and capital and the freedom of establishment, the Court referred the matter to the ECJ.

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Portugal - ECJ judgment in the Commission v Portugal case (*C-345/05*)**: treatment of capital gains arising from transfer of immovable property in Portugal**

On 26 October 2006, the ECJ decided that the Portuguese exemption from taxation on capital gains from transfers of immovable property violates Articles 18, 39 and 43 EC and Articles 28 and 31 EEA.

In September 2005, the Commission referred the Portuguese Republic to the ECJ concerning the provisions of Article 10(5) of the Personal Income Tax Code, which exempts from taxation capital gains arising from the transfer of immovable property intended for the taxable person's own and permanent residence, subject to the condition that the proceeds of the sale of the immovable property are re-invested in the purchase of immovable property situated in the Portuguese territory.

The Commission claimed that the condition to re-invest the sales proceeds in other immovable property situated in Portuguese territory clearly constituted an impediment to the fundamental freedoms guaranteed by the EC and EEA treaties on the free movement of persons and capital and the freedom of establishment.

As Article 10(5) of the Personal Income Tax Code cannot be justified by overriding reasons of the public interest, the ECJ considered that by maintaining in force such tax provisions Portugal has breached Articles 18, 39 and 43 EC and Articles 28 and 31 of the EEA Agreement.

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UK – ECJ judgment in the Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v CIR case *(C-196/04)***: UK CFC rules limited to "wholly artificial arrangements"**

On 12 September 2006, the ECJ held that the UK CFC regime is *prima facie* contrary to the freedom of establishment provisions of the EC Treaty, but the breach may be justified provided it applies only to 'wholly artificial arrangements' which do not reflect economic reality.

Cadbury Schweppes Plc through its UK subsidiary Cadbury Schweppes Overseas Limited, held 100% of the shares in two Irish companies, Cadbury Schweppes Treasury Services (CSTS) and Cadbury Schweppes Treasury International (CSTI), which carried out treasury activity. CSTS and CSTI were subject to the Irish 10% IFSC Corporation Tax Rate. The UK Revenue claimed £8.6 million tax from CSO in respect of the profits of CSTI in 1996 under the UK CFC rules (no amount was claimed in respect of CSTS as it made a loss in the period).

The UK Special Commissioners referred the following question to the ECJ:

> "Do Articles 43 EC, 49 EC and 56 EC preclude national tax legislation such as that in issue in the main proceedings, which provides in specified circumstances for the imposition of a charge upon a company resident in that Member State in respect of the profits of a subsidiary company resident in another Member State and subject to a lower level of taxation?"

The ECJ made it clear that the fact that there is a tax reduction motive for the existence and operation of a CFC does not necessarily mean that it constitutes a wholly artificial arrangement. Similarly, the fact that the activities could have been carried out by a UK resident company does not necessarily mean that there is a wholly artificial arrangement.

However, the ECJ's guidance on what may constitute a wholly artificial arrangement is limited, and refers simply to the extent to which the CFC physically exists in terms of premises, staff and equipment, and consequently the finding that the local incorporation corresponds with an actual establishment intended to carry on genuine economic activities in the host Member State.
See also EUDTG Newsalert NA 2006 – 22.

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NATIONAL DEVELOPMENTS

Finland – Lower level rulings on cross-border group contributions

The Finnish Central Tax Board has handed down a ruling on the deductibility of Finnish group contributions in cross-border situations (KVL 62/2006). The facts of the case covered so-called Marks & Spencer losses, i.e. foreign losses that could not be utilized in the country where they had occurred. The Central Tax Board rejected the deductibility of the contribution because the contribution was not given for Finnish-based business activity.

The Central Tax Board's ruling is not binding, and an appeal has been lodged with the Finnish Supreme Administrative Court which in turn may refer the question to ECJ. As the pending ECJ *Oy AA case (C-231/05)* does not cover such final Marks & Spencer losses, it is unlikely that the ECJ will comment on this issue in its forthcoming judgment in the present case. Therefore, it is likely that there will be a need for a second ECJ case after the judgement in the Oy AA case.

Finnish tax literature (in line with the international literature) has interpreted the Marks & Spencer judgment in such a way that it should be possible to offset foreign unusable losses against cross-border group contributions within an international group. However, the Finnish lower level courts and the Tax Administration appear still to refuse applying the ECJ's judgment over the wording of the Group Contribution Act in the absence of a precedent in this respect.

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Germany – Federal Tax Court holds 5% non-deductible expense on foreign dividends incompatible with EU law - even in third country cases

In a decision dated 9 August 2006 and published on 9 November 2006, the German Federal Tax Court decided that the version of section 8b para 5 of the Corporation Tax Act (CTA) which was applicable until 2003, is not compatible with Article 43 (freedom of establishment) and Article 56 (free movement of capital) of the EC Treaty - even where it applies to a third country investment (here a South African Ltd.).

According to section 8b para 5 CTA, which applies to corporations, a foreign tax-exempt dividend triggered deemed non-deductible expenses of 5% of the dividend irrespective of whether the corporate shareholder had incurred cost related to the foreign investment. Domestic dividends were equally tax-exempt. Non-deductible expense, however, only arose with respect to expenses directly related to the investment and actually incurred (section 3c para 1 Income Tax Act). Where the actual expense directly related to a foreign investment did not reach 5% of the dividends received, the investment in a foreign corporation was treated worse than the investment in a domestic corporation. Section 8b para 5 CTA applies to both foreign and domestic dividends since 2004.

Taking into account the ECJ's judgments in the 2003 Dutch *Bosal Holding* case and the 2006 German *Keller Holding* case *(C-168/01 and C-471/04)*, the Federal Tax Court's decision is not surprising. The different treatment of foreign and domestic dividends as triggered by section 8b para 5 CTA was already judged incompatible with Article 43 and 56 EC.

As the plaintiff had not suffered any expense related to the foreign investment, the Federal Tax Court explicitly left open the question whether the provision for domestic dividends - non-deductibility of actual expense up to the amount of the dividend - could be applied instead.

The most sensational element of the Federal Tax Court's decision is the fact that the dividend received by the plaintiff was not coming from an EU resident but from a third country participation for which protection is exclusively granted by Article 56 EC (free movement of capital) and not by Article 43 EC (freedom of establishment). Numerous cases are pending with the ECJ and no case in the area of taxes has been decided so far. In *Fidium Finanz* (see above), which is a non-tax case, the ECJ held that Article 56 EC was not applicable in a third country situation, which - in a pure EU case - would rather be dealt with under Article 49 EC (freedom to provide services) than Article 56 EC. See also EUDTG Newsalert NA 2006 – 15.

-- Thomas Brink and Juergen Luedicke, Germany; juergen.luedicke@de.pwc.com

Norway – Extended right to claim refund of Norwegian tax on dividends (inbound and outbound)

The Norwegian Supreme Court has ruled in a case regarding taxation of inbound dividends. A Norwegian company had been taxed on dividends from a Swedish company in 2000, even though the dividends would have been tax free had they been received from shares in a Norwegian company. The Norwegian company did not file a tax claim until 2004, i.e. after all normal time limits for challenging the tax assessment had expired.

The Supreme Court sustained the company's primary allegation entitling the company to pursue the claim for repayment in civil proceedings, based on compensation and/or repayment obligations for the state under the EEA Agreement. The Court found that a legal claim on that basis falls outside the scope of the time limits in the tax law.

In relation to the alternative claims for annulment of the tax assessment, the Court also found that the company was entitled to a reinstatement of the time limits as applied under Norwegian tax law. It should be quite clear that the ruling has consequences not only for inbound dividends, but also for outbound dividends.

As a result, EU/EEA based shareholders should file a claim for compensation or refund of Norwegian withholding tax paid on dividends (also) before 2003. Because of the 1 year time limit to file claims for compensation in civil proceedings and the fact that Norway officially accepted such claims up to 27 January 2006, such claims will have to be filed before 27 January 2007. It remains uncertain whether claims can be made back to 2000 (*Verkooijen; C-35/98*) or for all the years since the introduction of the EEA Agreement in 1994. It should be added that the Norwegian tax authorities might disagree with the fact that the statute of limitations for old cases should be 27 January 2007. Claims for refunds of withholding tax for 2003 and later years have been accepted based on the three-year statute of limitation for reassessment under the Norwegian tax law. For refunds of withholding tax relating to 2003, such reassessment claims must therefore be filed by 31 December 2006.

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Switzerland – Double Tax Treaty between Switzerland and Spain: revision protocol signed, Savings Tax Agreement becomes applicable

A protocol amending the double tax treaty between Switzerland and Spain was signed on 29 June 2006. The most important changes refer to:

- withholding tax relief on cross-border payments of dividends, interest and royalties among related companies;
- general withholding tax relief on interest payments;
- the introduction of an information exchange clause and the extension of administrative assistance also to "tax fraud and the like" cases as well as for holding companies.

With the exception of royalty payments (for which the withholding tax relief will apply as from 1 July 2011), the revised clauses will take effect as from the entry into force of this protocol (upon the still pending official approval by the competent authorities of both States, this being the parliament on the part of Switzerland). In this context it is important to note that Switzerland does not levy withholding tax on royalties according to domestic law. With the entry into force of the revised treaty (not yet known), Article 15 of the Switzerland-EU Savings Tax Agreement (withholding tax relief on dividends, interest and royalty payments) becomes applicable with immediate effect also with respect to Spain (subject to the royalty transitional period mentioned above).

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UK – Cross border loss relief: Marks & Spencer appeal hearing

The cross border loss relief case of Marks & Spencer plc v Halsey (*C-446/03*) was referred back to the UK courts after the ECJ delivered its judgment on 13 December 2005. On 10 April 2005, a UK High Court judge held that the UK restriction on group relief for losses not being available for non-UK resident subsidiaries should only be disapplied in situations where the losses could not be used locally. Marks & Spencer have appealed against the High Court decision and the UK Court of Appeal is hearing the appeal on 16 and 17 November 2006.

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UK – Implementation of Hoechst decision: Deutsche Morgan Grenfell case

Prior to the abolition of advance corporation tax (ACT) in 1999, where a UK company entered into a group income election with its parent company, it was not required to pay ACT in respect of dividend payments made to the parent company. However, only UK resident companies were permitted to make a group income election. Consequently, a UK resident subsidiary of a UK resident parent company could pay a dividend to its parent without paying ACT, but a UK resident subsidiary of an EU parent company was required to pay ACT on dividends paid to its parent company.

On 8 March 2001, the ECJ ruled in the joined *Hoechst* and *Metallgesellschaft* cases *(C-410/98 and C-397/98)* that the UK group income election rules relating to dividends were in breach of the EC Treaty. Further claims were linked in a consolidated action (a Group Litigation Order or "GLO"). The GLO was divided into 3 classes based on specific characteristics of the claims and Class 1 related to claims mainly by French and German parented companies where the parent was not entitled to a tax credit under the relevant double taxation treaty. The UK Revenue authority (HMRC) has negotiated settlements for Class 1 claimants subject to agreement of the periods to which claims can be referred back.

Deutsche Morgan Grenfell (DMG) is a test case for Class 1 claims. On 4 February 2005, the UK Court of Appeal held that claims for repayment of ACT must have been made within 6 years of payment of the ACT. However, the House of Lords (the UK Supreme Court) has now overruled that decision and held that DMG paid the ACT under a mistake of law, and that the mistake was discovered when the ECJ delivered its Judgment in the Hoechst case in March 2001. The period of limitation therefore runs for 6 years from the date of the ECJ judgment in the Hoechst case (March 2001) and not (as the Court of Appeal held) the date of payment of the ACT. As a result, claimants in the GLO may now be entitled to compensation for all ACT paid on dividend payments to foreign parent companies, irrespective of the date of payment of the ACT (and possibly going back to the introduction of ACT in 1973).

Note, however, that UK legislation was amended in 2004 in response to the DMG legislation, such that the time limit for restitution of direct taxes based upon mistake is now 6 years from the date the tax was paid (five years in Scotland). The amendments have effect for actions brought on after 8 September 2003, and to amendments to existing actions made on or after 20 November 2003. Prima facie, companies will only be able to benefit from the House of Lords decision to the extent that they made claims before the legislation was amended. However, it is arguable that the amended legislation is itself contrary to EC Law, as it does not introduce a transitional period for taxpayers to lodge claims that would otherwise be out of time. This point will be dealt with in the FII GLO action, probably on its return to the UK High Court next year.

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EU DEVELOPMENTS

Direct taxation: Commission requests Greece to end discriminatory taxation of dividends from foreign companies

On 17 October 2006, the European Commission formally requested Greece to end the discriminatory taxation of dividends paid by foreign companies. Greece exempts dividends paid by resident Greek companies to individual shareholders but it taxes dividends from non-resident companies. The aim of the exemption is to avoid the double taxation of company profits when the profits are taxed first at the level of the company and secondly at the level of the individual shareholders when distributed as dividends. In contrast, dividends paid by companies from other Member States to individual shareholders are not exempt. The Commission considers this differential treatment contrary to the EC Treaty and a restriction of the free movement of capital based on the *Verkooijen case* (*C-35/98*). The Commission adds that where the individual shareholder has control over the foreign company the difference in treatment is a restriction of the freedom of establishment. It furthermore argues that dividends paid from other Member States cannot be subjected to higher taxes than dividends paid from within the Member State.

The request is in the form of a Reasoned Opinion under Article 226 EC. If Greece does not reply satisfactorily to the request within two months the Commission may refer the matter to the ECJ.

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Ireland and Poland – Commission requests Ireland and Poland to end the discriminatory treatment of foreign charities

On 17 October 2006, the European Commission sent both Ireland and Poland a formal request to end their discriminatory treatment of foreign charity organisations, having in July 2006 previously sent a formal request to the UK.

Polish tax law allows for a tax relief for gifts to charities but only if they are established in the territory of Poland. Charities established in other Member States are excluded from this favourable tax treatment. Ireland has a similarly favourable tax relief provision for gifts to charity organisations for Irish-based charities only.

The Commission considers that foreign charities are therefore discriminated against by the Irish and Polish tax laws. EU Tax Commissioner Kovács has stated that this difference in tax treatment of domestic and foreign charities constitutes an infringement of the EC Treaty, which was confirmed by the ECJ in the Stauffer case (see above).

The formal requests were issued under Article 226 EC in the form of a Reasoned Opinion. Both EU Member States are obliged to reply satisfactorily to the request within two months, otherwise the Commission may refer the case to the ECJ.

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Italy – Commission requests information from the Italian Government on tax relief for consumer cooperatives

On 4 August 2006, the Commission requested information from the Italian Government on the tax relief for the consumers' cooperatives provided for by Italian law. The tax relief principally consists of a reduction of the taxable income and some other tax regimes and may constitute State aid incompatible with the EC Treaty. At the end of September 2006, the Italian Government explained in detail to the Commission the characteristics of the Italian law regarding the cooperatives and the reasons for which, in its opinion, the Italian legislation is not in breach of the EC Treaty. Should the reply of the Italian Government be considered as not exhaustive by the Commission, then an infringement procedure against Italy will be started.

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Spain – Commission opens second infringement procedure against Spain over capital gains discrimination

On 17 October 2006, the European Commission opened a second infringement procedure against Spain for its non-compliance with the ECJ's judgment in the Commission v Spain case (*C-219/03*). In the 9 December 2004 judgement, the ECJ ruled in favour of the Commission that Spain had violated the principles of the freedom to provide services (Article 49 EC) and the free movement of capital (Article 56 EC) by maintaining a less favourable tax regime on capital gains on shares of companies not established in Spain.

The Spanish Personal Income Tax Act provides a tax relief for transfers of fixed assets, including shares, acquired prior to 1 January 1995. The relief for shares listed in Spanish Stock Exchanges is 25% per year of tenure or fraction thereof before 1 January 1995, while for other shares the tax relief is 14.28% per year of tenure or fraction thereof before the same date.

As the Commission has not been informed of amendments to the Spanish legislation to comply with the said ECJ judgment, the Commission has now started a second infringement proceeding.

Also in the second half of October 2006, the Spanish Parliament enacted a major amendment to the Personal Income Tax Act. Upon entry in force of the amendments, expected as of 1 January 2007, disposals of assets carried out after 20 January 2006 will be fully taxable for the part of the capital gain attributable to the period beyond 20 January 2006 to the disposal date. The tax relief will continue to apply for the part of the capital gain attributable to the period elapsed from the acquisition date through 19 January 2006.

Under this amendment, the 25% relief rate will now apply to securities traded in any of the Stock Exchanges regulated by Directive 2004/39 EC.

On the basis of the Commission's infringement proceedings and the Spanish national law amendments, taxpayers should consider the following:

- for disposals of shares listed in EU stock exchanges already carried out, filing protective claims to ensure that their rights under Spanish Law are not jeopardised by the four-year Spanish domestic Statute of Limitations period; and

- for assets currently held, analysing the convenience of disposing of such assets before or after 1 January 2007.

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ABOUT THE EUDTG

The EUDTG is one of PricewaterhouseCoopers' Thought Leadership Initiatives and part of the International Tax Services Network. The EUDTG is a pan-European network of EU tax law experts and provides assistance to organizations, companies and private persons to help them to fully benefit from their rights under EU law. The activities of the EUDTG include organising tailor-made client conferences and seminars, performing EU tax due diligence on clients' tax positions, assisting clients with their (legal) actions against tax authorities and litigation before local courts and the ECJ. EUDTG client serving teams are in place in all 25 EU Member States, most of the EFTA countries and Switzerland. See the EUDTG website for more information: www.pwc.com/eudirecttax.

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