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CONTENT

ECJ Cases

Belgium	ECJ judgment on Belgian foreign tax credit regime (Kerckhaert-Morres case)
Belgium	ECJ judgment on withholding tax on construction works carried out by non-registered contractors (Commission v Belgium case)
Belgium	A-G opinion on the application of a minimum tax base for non-residents (Talotta case)
Finland	ECJ judgment on taxation of non-residents´ pension income (Turpeinen case)
France	ECJ judgment on withholding tax on outbound dividends (Denkavit case)
Germany	Referral to the ECJ on transitional corporation tax rules
Netherlands	A-G opinion on non-discriminatory tax measures
Netherlands	A-G opinion on free movement of capital and minority and majority shareholdings in the Czech Republic under the Europe Agreement and Art. 56 and 57 EC
UK	ECJ judgment on corporation tax treatment of inbound dividends (Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue case)
UK	ECJ judgment on corporation tax treatment non-resident shareholders (Class IV of the ACT Group Litigation v Commissioners of Inland Revenue case)

National Developments

Finland	Implementation of 2005 amendments to EU Merger Directive
France	Supreme Court rules tax on advertising expenses incurred by companies is State aid not compatible with EC Law
Germany	Tax bills enacted
Netherlands	Association Agreement with Turkey prohibits restrictions of freedom of establishment
Netherlands	Court of Appeal refuses cross-border fiscal unity
Portugal	Binding information on thin capitalisation rules
Portugal	State Budget 2007
Spain	Tax court ruling against Spanish pre-2004 thin capitalisation rules
Sweden	Swedish Tax Board for Advance Rulings decided in a case regarding exit taxation upon corporate migration
Sweden	Swedish Tax Board for Advance Rulings decided in two cases regarding cross b order tax consolidation
Switzerland	Swiss parliament approves the revision protocol of the Swiss-Spanish Double Tax Treaty

UK	Amendments to controlled foreign company rules following ECJ judgment in the Cadbury Schweppes case
UK	Reduction in time limit for mistake of law claims

EU Developments

Belgium	Commission requests Belgium to amend tax discriminatory rules on donations to foreign charities
EU	Commission unfolds new proposals for closer coordination of EU national direct tax systems, including exit taxes and cross-border loss relief
EU	Commission consults with business and academics on CCCTB
France	French fiscal economic interest groups (EIGs) constitute incompatible State aid
Switzerland	Extension of the EU – Swiss Savings Tax Agreement to Bulgaria and Romania

ECJ CASES

Belgium – ECJ judgment on Belgian foreign tax credit regime: Kerckhaert-Morres case (C-513/04)

On 14 November 2006, the ECJ ruled against the taxpayer in the Kerckhaert-Morres Case relating to the denial of providing a tax credit/set-off for the tax levied at source in another Member State.

The ECJ concluded that Belgian tax legislation which applies a uniform tax rate to dividends from resident companies and those from companies located in other EU Member States without providing for the possibility of setting off tax levied by deduction at source in that other Member State is not against EC Law. See also EUDTG Newsalert NA 2006 – 32.
-- Caroline Goemaere and Olivier Hermand, Belgium; olivier.hermand@pwc.be

Belgium – ECJ judgment on withholding tax on construction works carried out by non-registered contractors: Commission v Belgium case (C-433/04)

On 9 November 2006, the ECJ decided that Belgium had failed to fulfil its obligations under the Treaty by obliging principals and contractors to withhold 15% of the sum payable for work carried out by foreign contracting partners not registered in Belgium and by imposing joint and several liability for the tax debts of such contracting partners on those principals and contractors.

Belgian tax legislation stipulates that principals and contractors who have recourse to (sub-) contractors who are not registered in Belgium at the time a contract for construction works is concluded, are jointly and severally liable for the payment of that (sub-)contractor's tax debts. Belgian tax law further stipulates that principals or contractors who pay (sub-)contractors who are not registered at the time of payment of the construction works should withhold 15% of the sum invoiced and pay that amount to the Belgian authorities.

On 23 October 2001, the Commission had notified Belgium that it considered these rules incompatible with Articles 49 and 50 (freedom to provide services) of the EC Treaty.

As a first argument the Belgian Government argued that since the disputed measures apply equally to contracting partners that are undertakings established in Belgium and to undertakings established in another Member State, the Commission failed to prove that Belgian operators are less inclined to have recourse to unregistered contracting partners established in another Member State than to unregistered Belgian contracting partners. The ECJ replied that it consistently held that Article 49 EC requires not only the elimination of all discrimination on grounds of nationality against service providers who are established in another Member State, but also the abolition of any restriction on the freedom to provide services, even if it applies without distinction to national providers of services and to those of other Member States.

As a second argument the Belgian Government contended that the measures were justified by overriding requirements relating to the public interest in the prevention of tax fraud in the construction sector. The ECJ did not accept the justification as the measure automatically and unconditionally applies regardless of the individual circumstances of service providers who are not established and not registered in Belgium and were consequently disproportionate.

The ECJ proposes two modifications to the Belgian regime. As regards the withholding obligation, the provision can be replaced by a system, based on exchange of information between principals and contractors, their contracting partners and the Belgian tax authorities, allowing, for example, to introduce an obligation to inform the Belgian tax authorities of any contract concluded with unregistered contracting partners or any payment made to them. As regards the joint and several liability, the provision can be replaced by allowing the service providers to prove the compliant status of their tax situation or to allow principals and contractors to avoid joint and several liability by taking certain steps in order to satisfy themselves as to the tax-compliant status of the service providers with whom they wished to contract.
-- Caroline Goemaere and Olivier Hermand, Belgium; olivier.hermand@pwc.be

Belgium – A-G Opinion on the application of a minimum tax base for non-residents: Talotta case (C-383/05)

On 16 November 2006, A-G Mengozzi concluded that the application of a minimum tax base for non-residents as laid down in Belgian tax law constitutes an indirect discrimination which cannot be justified.

In the absence of proper accounting or other conclusive evidence substantiating a taxpayer's taxable profit, the Belgian Income Tax Code ("BITC") provides for taxation on the basis of profits normally derived by similar taxpayers taking into account a variety of criteria (e.g. the invested capital, turnover, number of workers, etc). The BITC further provides for a minimum lump-sum taxable basis for foreign companies active in Belgium depending on the nature of its activities which cannot, in any event, be lower than €9.500.

The Belgian Supreme Court referred the question whether the minimum taxable basis for foreign companies is contrary to Article 43 (freedom of establishment) for a preliminary ruling to the ECJ.

It should be noted that as from tax year 2005 (financial years ending on 31 December 2004 and later) these provisions also apply to resident companies that have not or have not timely filed their tax return.
-- Caroline Goemaere and Olivier Hermand, Belgium; olivier.hermand@pwc.be

Finland – ECJ judgment on taxation of non-residents´ pension income: Turpeinen case (C-520/04)

The ECJ rendered its judgment in this case on 9 November 2006 and ruled that the Finnish withholding tax treatment with respect to pension income received by non-residents was incompatible with the freddom to reside and move freely within the EU (Art. 18 EC).

Ms. Turpeinen, a Finnish national living abroad (first in Belgium and then in Spain) since 1998, was considered non-resident for Finnish tax purposes as from 2002. In 2002 her worldwide income consisted only of Finnish-source pension payments from her earlier public service. The Finnish – Spanish tax treaty assigned taxing rights on this income to Finland. Under Finnish law, such earned income received by non-residents was taxed at the flat rate of 35 %, whereas residents were taxed at progressive rates between 0 and 55 %. In fact, Ms. Turpeinen had in 1999-2001, when still considered resident for Finnish tax purposes, been subject to taxes at 28.5 % on the same income.

The ECJ first concluded that Ms. Turpeinen, as a non-resident, had been taxed more heavily than residents on similar income. The ECJ pointed out that, as a general rule, residents and non-residents are not in a comparable situation regarding the source of their income and of their personal ability to pay and family/personal circumstances. However, the ECJ applied the "Schumacker-rule" to the case at hand and stated that, insofar as the retirement pension paid in Finland constitutes all or almost all of their income, non-resident retired persons such as Ms Turpeinen are in the same situation as regards income tax as retired persons resident in Finland who receive the same retirement pension. In such a case, a different treatment could be justified only if it were based on objective considerations proportionate to the legitimate aim of the national provisions. The ECJ rejected all of the presented justifications of the different treatment.
See also EUDTG Newsalert NA 2006 – 31.
-- Jarno Laaksonen, Finland; jarno.laaksonen@fi.pwc.com

France – ECJ judgment on withholding tax on outbound dividends: Denkavit case (C-170/05)

On 14 December 2006, the ECJ ruled that the imposition of dividend withholding tax by France on dividends only to non-resident parent companies (including fellow members of the EU) as compared with, in almost all circumstances, the absence of French dividend withholding tax on dividends paid by similar French subsidiaries to a French parent company, was contrary to Article 43 EC (freedom of establishment).

In addition, the ECJ considered that the provisions of the relevant tax treaty should be taken into account in assessing the compatibility of the measure with Article 43 EC. The ECJ however held that the combined application of the Dutch-French double tax treaty and the Dutch participation exemption regime does not serve to overcome the effects of the restriction on freedom of establishment.

In the years 1987 to 1989 (before the Parent/Subsidiary Directive was in force), the Dutch resident Denkavit BV received dividends of 14.5 million French Francs from two French resident subsidiaries, from which 5% French withholding tax was deducted, in accordance with French domestic tax law and the Dutch-French double tax treaty. Although the latter provides for a tax credit for the French dividend tax withheld, in practice, the Netherlands did not give that credit because the dividend income was exempt from corporate income tax.
See also EUDTG Newsalert NA 2006 – 35.
-- Jacques Taquet and Franck le Mentec, France; jacques.taquet@fr.landwellglobal.com

Germany – Referral to ECJ on transitional corporation tax rules

On 20 September 2006, the lower tax court of Hamburg decided to refer a case concerning the transitional rules for taxation of capital gains applicable in 2001 to the ECJ.

As reported in EUDTG Newsletter Issue 2006 - nr. 004, the Federal Tax Court expressed serious doubts as to whether these transitional rules are compatible with Article 56 EC (free movement of capital) and therefore suspended the payment of the taxes in an interim decision until the final judgment in the same case.

The rules for taxation of capital gains for individuals were changed with the tax reform in year 2000. The rules prior to the tax reform stated that a capital gain is taxable if – for simplicity's sake - the participation amounts to a minimum of 10 %. The new rules lowered this threshold to a minimum

participation of 1 %. However, the transitional provisions state that the new rules start applying for domestic participations as of year 2002, whereas for participations in foreign corporations, they apply already in 2001.

In the case at hand, the claimant had sold a 2 % Italian participation in 2001 and was taxed on the capital gain. Had the participation been a domestic one, then the gain would have been tax exempt in 2001.

The lower tax court of Hamburg, with which the main issue is still pending, shared the doubts that the Federal Tax court expressed in respect of the breach of the free movement of capital through such differential treatment of domestic and foreign participations and referred the case to the ECJ.

The referral might also have impact on other similar transitional rules at that time in Germany, e.g. the differential transitional rules in 2001/2002 on tax effectiveness of depreciation.
-- Caroline Wunderlich and Juergen Luedicke, Germany; juergen.luedicke@de.pwc.com

Netherlands – A-G opinion on non-discriminatory tax measures

Until 1 January 2004 the Dutch Corporation Tax Act provided that gains acquired from a participation (at least 5% of the shares) in a subsidiary were not taxable. Costs relating to the participation were deductible only insofar they were indirectly instrumental in making profit that is taxable in the Netherlands. In the *Bosal case* (C-168/01) the ECJ held that this requirement infringes the Parent-Subsidiary Directive (90/435/EEC), interpreted in the light of the free movement provisions, as a Dutch parent company might be dissuaded from carrying on its activities through a subsidiary established in another Member State since, normally, such subsidiaries do not generate profits that are taxable in the Netherlands.

The present case concerns the application of the *Bosal* judgment to subsidiaries established in third countries and to intermediate holdings established within the EU with subsidiaries in third countries. A-G Wattel is of the opinion that *Bosal* cannot be applied to the subsidiaries established directly in third countries, as Article 57(1) EC – the stand still clause for restrictions which exist on 31 December 1993 – saves a possible restriction of the free movement of capital to third countries. With respect to costs relating to the subsidiaries established in third countries indirectly, A-G Wattel observes that under national law these costs are not deductible regardless whether the intermediate holding is a resident of the Netherlands or of another Member State. There is, therefore, no discrimination based on the place of residence of the intermediate holding. As a result, the possible restriction is saved under Article 57(1) EC, unless the national measure directly affects access to the market of another Member State. According to A-G Wattel, this is not the case with national tax measures which do not prohibit access to the market of another Member State or effectively protect the national market. The Dutch limitation on the deduction of costs does not have these effects but merely leads to higher costs for all parent companies with intermediate holdings in the Netherlands and in other Member States, respectively. A-G Wattel, therefore, finds against the taxpayer. The judgment of the Dutch Supreme Court is expected this year.

Opinion A-G Wattel, 29 September 2006 (published 27 October 2006), in Case 43.083
-- Sjoerd Douma, the Netherlands; sjoerd.douma@nl.pwc.com

Netherlands – A-G opinion on free movement of capital regarding minority and majority shareholdings in the Czech Republic under the Europe Agreement and Art. 56 and 57 EC

Until 1 January 2004 the Dutch Corporation Tax Act provided that gains acquired from a participation (at least 5% of the shares) in a subsidiary were not taxable. Costs relating to the participation were deductible only insofar they were indirectly instrumental in making profit that is taxable in the Netherlands. In the *Bosal case* (C-168/01) the ECJ held that this requirement infringes the Parent-Subsidiary Directive (90/435/EEC), interpreted in the light of the free movement provisions, as a Dutch parent company might be dissuaded from carrying on its activities through a subsidiary established in another Member State since, normally, such subsidiaries do not generate profits that are taxable in the Netherlands.

Because the above-mentioned limitation on the deduction of costs existed on 31 December 1993, this restriction was saved by Article 57(1) EC – the stand still clause – with respect to majority participations in third countries. As of 1997, however, a new element was added to the participation exemption as it was applicable until 2004. Currency exchange results – positive as well as negative – relating to the participation were also excluded from the taxable basis. Effectively, this new rule only applied in case of currency exchange results relating to non-resident subsidiaries. Currency exchange results – positive as well as negative – relating to resident subsidiaries were fully included in the taxable basis.

The taxpayer in the present legal proceedings holds minority and majority shareholdings in the Czech Republic. The financing of these shareholdings has led to interest costs and currency exchange losses. According to AG Wattel, the Dutch Supreme Court should refer the case to the ECJ with respect to i) the interpretation of Articles 56, 57 and 58 EC with respect to the post 31 December 1993 exemption of currency exchange results from the financing of minority and majority shareholdings in third countries, and ii) the interpretation of Article 61 (free movement of capital) of the Europe Agreement establishing an association between the EU and the Czech Republic (entry into force 01/02/1995).

Opinion AG Wattel, 28 November 2006, in Cases 43.338 and 43.339
-- Sjoerd Douma, the Netherlands; sjoerd.douma@nl.pwc.com

UK – ECJ judgment on corporation tax treatment of inbound dividends: Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue case (C-446/04)

The ECJ delivered its judgment in this case on 12 December 2006. The main question related to the differential UK corporation tax treatment of dividends received from UK resident companies (which are not chargeable to UK corporation tax) and dividends received from companies resident in other EU Member States (which are subject to UK corporation tax, subject to double taxation relief (DTR) for withholding tax and, where the UK recipient company has at least 10% of the voting rights in the foreign company paying the dividend, subject also to DTR for underlying tax).

The ECJ held that where the UK recipient company holds less than 10% of the voting rights in the EU company paying the dividend (and so is not entitled to double tax relief for underlying tax paid by the EU company), the differential UK corporation tax treatment is contrary to Article 56 EC (free movement of capital). In contrast, where the UK recipient company holds 10% or more of the voting rights in the EU company paying the dividend, there is no breach of either Article 43 EC (freedom of establishment) or Article 56, provided that the rate of tax applied to EU dividends is no higher than

the rate of tax applied to UK dividends and that the tax credit is at least equal to the amount paid in the Member State of the company making the distribution, up to the limit of the amount of the tax charged in the UK. It is for the UK courts to determine whether this is the case, and in doing so they must take account of not only the rate of tax but also the levels of tax.
-- Chloe Paterson and Peter Cussons, United Kingdom; peter.cussons@uk.pwc.com

UK – ECJ judgment on corporation tax treatment non-resident shareholders: Class IV of the ACT Group Litigation v Commissioners of Inland Revenue case (C-374/04)

The ECJ delivered its judgment in this case on 12 December 2006. Where a UK resident company pays a dividend to a UK resident shareholder, UK legislation grants a tax credit to the UK resident shareholder. However, where a UK resident company pays a dividend to a non-UK resident shareholder, there is no entitlement to a tax credit unless it is provided for under a double taxation agreement. The UK has double taxation agreements with some EU territories (such as the Netherlands) which provide for a tax credit on dividends paid by a UK resident company to a company resident in the other EU Member State. However, the UK's double tax agreements with other EU Member States (such as France and Germany) do not provide for such tax credits.

The ECJ has held that it was not contrary to either Article 43 (freedom of establishment) or Article 56 (free movement of capital):

(a) For the UK to grant a tax credit for a dividend paid by a UK resident company to another UK resident company, but not to grant a tax credit for a dividend paid by a UK resident company to a company resident in another EU Member State which was not subject to tax on dividends in the UK. Where the recipient of the dividend was subject to tax in the UK, then it is for the UK courts to determine whether there was a breach of the EC Treaty.

(b) For the UK to grant a credit under the terms of a double tax agreement with an EU member state (such as the Netherlands) in respect of dividends paid by a UK resident company to companies resident in that EU member state, but not to extend entitlement to a tax credit to companies resident in other EU member states (such as France or Germany) where the double taxation treaty did not provide for such a credit. In this regard, the ECJ followed its previous judgment in the *D* case (C-376/03), in holding that a double tax treaty between two EU Member States was confined to residents of those Member States. See also EUDTG Newsalert NA 2006 – 34.
-- Chloe Paterson and Peter Cussons, United Kingdom; peter.cussons@uk.pwc.com

Back to top

NATIONAL DEVELOPMENTS

Finland – Implementation of 2005 amendments to EU Merger Directive

The Finnish Parliament adopted in December 2006 new legislation implementing the amendments to the EU Merger Directive. The new legislation entered into force as from 1 January 2007 and includes provisions on partial divisions and additional share acquisitions by means of share-exchanges (i.e. acquisitions where the acquiring company already holds a majority share in the target company are now within the scope of tax neutral share-exchange). Legislation implementing the EC Merger Directive provisions with respect to European Companies (Societas Europaea) were adopted in 2005.

Also, amendments or clarifications concerning tax losses are included in the new implementation provisions. Firstly, tax losses of a company going through a division or partial division should be transferred to the new company continuing the business that the losses are connected to. If it is impossible to allocate losses in such manner, the losses should be allocated to the new companies in the same ratio as the assets received by them. Secondly, the treatment of tax losses of permanent establishments (PE) connected to reorganizations was amended/clarified. For example, if a foreign PE of a Finnish company is incorporated as foreign subsidiary, Finland now has claw-back provisions enabling Finland to increase the taxable income of the Finnish parent company with the amount of tax losses deducted in Finland that were connected to the foreign PE. In addition, if a Finnish PE of a foreign company becomes a Finnish PE of another foreign company due to reorganization, the tax losses connected to the PE shall be deductible also after the change of parent company.
-- Jarno Laaksonen, Finland; jarno.laaksonen@fi.pwc.com

France – Supreme Court rules tax on advertising expenses incurred by companies is State aid not compatible with EC Law

On 21 December 2006, the French Supreme Court ruled the French "tax on certain advertising expenses" ("taxe sur certaines dépenses de publicité") not compatible with EU law.

The tax is due by companies liable to VAT with a turnover above € 763,000 incurring selected types of advertising expenses. This tax used to be allocated to a specific fund dedicated to "press modernization" and not to the French Government itself. The Supreme Court ruled that the allocation of the tax to an ad hoc fund qualifies as a State aid, falling within the scope of article 87 of the EC treaty, which should have been referred to the European Commission for prior approval, as required by EU law. Subsequent to the Finance Bill for 2006, the tax is from now on allocated to the French Government.

Claims for refund can be filed up to 31 December 2008, in respect of taxes paid as from 2003.
-- Jacques Taquet and Franck le Mentec, France; jacques.taquet@fr.landwellglobal.com

Germany – Tax bills enacted

On 13 December 2006, the long awaited tax bill on, inter alia, accompanying tax measures for the implementation of the Societas Europaea and changes of other Tax Acts went into force.

As reported in EUDTG Newsletter Issue 2006 - nr. 003, the bill e.g. seeks to implement the Merger Directive 90/434/EEC and 2005/19/EC and to secure the taxation of undisclosed reserves in assets leaving the German tax jurisdiction.

As opposed to the initial considerations that included all foreign equivalents to mergers, divisions, partial divisions and changes of form in the German Reorganisation Tax Act, the final bill only includes foreign restructurings where the parties are companies founded in accordance with the laws of an EU/EEA Member State with seat and place of management within the EU/EEA. The final bill contains, in accordance with the drafts, the general principle that reorganisations are carried out at market value, i.e. are taxed. Upon application, they can be carried out at book value, provided that Germany does not lose its right to tax gains in the assets/shares post reorganisation.

As in the drafts, the general rule is that there will be a deemed disposal when assets leave the German tax jurisdiction, i.e. when Germany loses the right to tax the capital gains upon disposal of the assets. Where assets are transferred from a German head office to a foreign permanent establishment within the EU (note: not EEA), it is possible to pay the taxation over five years, however, with immediate taxation of the whole amount should the asset for example be disposed of within this period. This only applies in case the head office is located in Germany; there is no deferral if assets are transferred from a German PE to an EU head office.

The transfer of registered office of a Societas Europaea is tax neutral where the German assets remain with a PE in Germany and are thus equally taxable post transfer. Assets that leave the German taxing jurisdiction upon such transfer of seat are taxed in accordance with the general rule. Special rules govern the deferred taxation of the capital gain of the shares in the SE upon later disposal.

Whether the German bill is in accordance with ECJ case law in respect of exit taxes (see the *de Lasteyrie du Saillant* (C-9/02) and *"N"* (C-470/04) cases) seems questionable. On 19 December 2006, the Commission issued a Communication on exit-taxation and the need for coordination of Member States' tax policies (see also below). The Commission is of the opinion that the principles in e.g. de Lasteyrie apply also to assets of a Societas Europaea that are transferred in connection with a transfer of seat, i.e. these shall not be taxed upon migration. Further, the Commission holds that taxation upon transfer of assets between head office and PE or the other way around is likely to be contrary to the EC Treaty freedoms.

A second tax bill went into force on 19 December 2006. This contains for example a tightening of the rules for withholding tax relief under a double tax treaty or the Parent/Subsidiary Directive. This treaty or directive shopping rule contains elements that might render it contrary to the Parent/Subsidiary Directive. Relief will e.g. in certain cases not be granted, where the major activity of the foreign parent company consists of asset management.
-- Caroline Wunderlich and Juergen Luedicke, Germany; juergen.luedicke@de.pwc.com

Netherlands – Association Agreement with Turkey prohibits restrictions of freedom of establishment

Until 1 January 2004 the Dutch Corporation Tax Act provided that gains acquired from a participation (at least 5% of the shares) in a subsidiary were not taxable. Costs relating to the participation were deductible only insofar they were indirectly instrumental in making profit that is taxable in the Netherlands. In the *Bosal case* (C-168/01) the ECJ held that this requirement infringes the Parent-Subsidiary Directive (90/435/EEC), interpreted in the light of the free movement provisions, as a Dutch parent company might be dissuaded from carrying on its activities through a subsidiary established in another Member State since, normally, such subsidiaries do not generate profits that are taxable in the Netherlands.

As of 1997 a new element was added to the participation exemption as it was applicable until 2004. Currency exchange results – positive as well as negative – relating to the participation were also excluded from the taxable basis. Effectively, this new rule only applied in case of currency exchange results relating tot non-resident subsidiaries. Currency exchange results relating to resident subsidiaries were fully included in the taxable basis.

The taxpayer in the present legal proceedings holds majority shareholdings in Turkey. The financing of these shareholdings has led to currency exchange losses. According to a District Court of Haarlem ruling of 31 October 2006 (case nr. 06/3471), this results in a prohibited restriction of the freedom of establishment enshrined in Article 41(1) of the Additional Protocol to the Association Agreement between the Member States of the European Union and Turkey (entry into force 1 January 1973). This provision states that the Contracting Parties shall refrain from introducing between themselves any new restrictions on the freedom of establishment and the freedom to provide services. Restrictions of the freedom of establishment vis-à-vis Turkey are prohibited under the Association Agreement if they have been introduced after 1 January 1973, the Court said.
-- Sjoerd Douma, the Netherlands; sjoerd.douma@nl.pwc.com

Netherlands – Court of Appeal refuses cross-border fiscal unity

On 31 October 2006 the Court of Appeal of The Hague refused to refer preliminary questions to the ECJ regarding the Dutch full tax consolidation regime (fiscal unity for corporate income tax purposes). Although the impossibility to form a fiscal unity between the Dutch parent company and its Belgian subsidiary constitutes a restriction of the freedom of establishment, the restriction is justified by the principle of territoriality, the Court of Appeal said.

The proceedings in The Hague were somewhat of a rearguard action, since the matter is currently pending with the Dutch Supreme Court in another case (see EU Tax News - Issue 2006 – nr. 5). It is expected that the Supreme Court will refer that case to the ECJ, as the application of the *Marks & Spencer* criteria (C-446/03) would lead to the conclusion that a cross-border fiscal unity should be possible.
-- Sjoerd Douma, the Netherlands; sjoerd.douma@nl.pwc.com

Portugal – Binding information on thin capitalisation rules

From January 1996 to December 2005, thin capitalisation rules in force in Portugal stipulated that where the indebtedness of a Portuguese taxpayer towards a non-resident entity with whom special relations ("associated enterprise") exist and is deemed excessive (when the debt exceeds twice the equity, i.e. at a 2:1 ratio), the interest paid in relation to the part of the debt that is considered to be excessive will not be deductible for the purposes of assessing taxable income. The State Budget for 2006, in force from 1 January 2006 onwards, stipulated that the Portuguese thin capitalisation rules do not apply in case the non-resident entity is resident in an EU Member State.

According to a recent binding ruling, as a result of the ECJ decision in the *Lankhorst-Hohorst* case (C-324/00), the Portuguese thin capitalization rules must be interpreted in the light of the Lankhorst-Hohorst case. Consequently, tax inspectors are requested not to disallow excessive interest expenses in EU situations in years before 2006. Additionally, on 21 July 2006, the Administrative and Tax Court of Lisbon ruled that Portuguese thin capitalisation rules in force until December 2005 are incompatible with the fundamental freedoms guaranteed under the EC Treaty, namely the freedom of establishment, services and capital (Arts. 43, 49 and 56 of EC Treaty).
-- Leendert Verschoor, Portugal; leendert.verschoor@pt.pwc.com

Portugal – State Budget 2007

The State Budget for the year 2007, among other measures, has introduced changes in corporate income tax law, following the transposition of the EU Parent-Subsidiary Directive. Accordingly, there is a reduction to 15% (from 20%) of the minimum participation required to qualify for exemption from withholding tax on outbound dividends paid by Portuguese subsidiaries to their EU parent or to an EU-based permanent establishment of another EU parent company, provided that the parent and subsidiary concerned comply with the conditions set out in the Directive.

In line with the agreement concluded between the EU and Switzerland, the State Budget has also established an exemption from withholding tax on outbound dividends paid by Portuguese subsidiaries to their Swiss parent, as long as the requirements are met (among others 25% minimum direct participation, owned for two years).

Additionally, the State Budget proceeds with changes in corporate income tax law, following Council Directive 2005/19/EC amending the Directive 90/434/EEC on the common taxation system of cross-border merger and division of companies, transfer of assets and exchanges of shares (the EC Merger Directive).

Concerning Personnel Income Tax (PIT), the State Budget for 2007 has also introduced some relevant changes. The rule in force until December 31, 2006, concerning interest paid by non-residents to a resident individual, stated that such income should be aggregated with the other taxable income, for purposes of taxation and as such subject to the marginal tax brackets. According to the rule introduced by the State Budget for 2007, this interest will be subject to taxation at a rate of 20% (such as applies in case of interest received from entities resident in Portugal).
-- Leendert Verschoor, Portugal; leendert.verschoor@pt.pwc.com

Spain – Tax court ruling against Spanish pre-2004 Thin Capitalisation Rules

The Spanish Central Economic-Administrative Court has ruled (Decision 00/2396/2004) that Spanish pre-2004 thin capitalization rules should not be applied to borrowings from EU residents, under the ECJ Ruling in the *Lankhorst-Hohorst* case (C-324/00). The Spanish thin capitalisation rules, which referred to all foreign borrowing, were amended as of 1 January 2004. In order to comply with the ECJ Lankhorst-Hohorst ruling, the amendment excluded borrowing from EU Member States from the scope of the Spanish thin capitalisation rules.

In view of the above, taxpayers who have suffered thin cap adjustments on intra-EU borrowings should consider filing amended tax returns for pre-2004 tax years, before expiry of the four-year statute of limitations period.
-- Carlos Concha Carballido, Ramon Mullerat and David Benito, Spain;
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Sweden – Swedish Tax Board for Advance Rulings decided in a case regarding exit taxation upon corporate migration

On 26 September 2006, the Swedish Tax Board for Advance Rulings decided in a case regarding exit taxation upon corporate migration, and found the Swedish tax provisions to be disproportionate in the light of the EU provisions. However, the provisions were believed justifiable if applied at a later occasion when the assets were actually disposed of.

The case concerned a Swedish company with its main assets being UK real property, which decided to migrate its tax residence (for treaty purposes) to Malta. The questions related to the allowability of the Swedish domestic provisions on exit taxation upon corporate migration and on return to income of certain tax accruals reserves.

The Tax Board decided that the migration triggered exit tax and reversal of the tax reserves according to domestic provisions but that Articles 43 and 48 EC (freedom of establishment) and the principles of equality indeed prevented immediate taxability.

In the reasoning for support of the decision, the Tax Board found that although disproportionate, the domestic tax claims were legitimate and could in respect of the exit tax be justified if taxability only occurred at the year of actual disposal of the assets (and for the reversal of the reserves, in line with the normal rules for reversal after six years). The Tax Board also found that the Sweden-Malta tax treaty would not interfere with such Swedish taxability as the treaty only is concerned with income derived after tax residence in Malta has been gained.

The ruling is likely to be appealed to the Supreme Administrative Court (where an ECJ referral also might occur) and interestingly enough the criteria for future taxability are not mentioned in the actual decision but just in the reasoning. Some references are also made to the principles of the *"N" case (* C-470/04). The Presenter at the Tax Board expressed a dissenting opinion as regards the reasoning (only), and stated that such future tax claims based on community law were vague and in the absence of domestic provisions regulating such situations, exit taxes should not be due at a later occasion either. This author is inclined to agree with the latter viewpoint.
-- Gunnar Andersson, Sweden; gunnar.andersson@se.pwc.com

Sweden – Tax Board for Advance Rulings decided in two cases regarding cross border tax consolidation

On 29 September 2006, the Swedish Tax Board for Advance Rulings decided in two cases regarding cross border tax consolidation, and the decisions seem very much inspired by the *Marks & Spencer* case (C-446/03). The two rulings are likely to be appealed to the Supreme Administrative Court (where an ECJ referral also might occur). As a background, Swedish qualifying groups are entitled to tax consolidate by way of group contributions, deductible for the contributor and taxable for the recipient. Among the requirements are that the entities are Swedish or/and taxable in Sweden.

In the first case the Tax Board agrees to a tax deduction for group contributions for a Swedish parent company, for contributions given to a Dutch subsidiary with losses. The reasoning is very much in line with the M&S case. The deduction is however only granted at the stage of liquidation of the subsidiary (and the case also contained deductions for group contributions to other loss making subsidiaries in other countries, which thus were rejected since it had not been shown that these losses could not be utilized in the future). The ruling also discussed the issue of taxability of the contribution for the foreign subsidiary, and seems not to regard that as a vital issue. Also the amount of deduction was discussed, and the conclusion was that that the lesser of the loss amount, computed according to Swedish and Dutch provisions respectively, would be guiding.

In the second case the Tax Board refused tax deduction for group contributions from a Swedish subsidiary to its Finnish parent company. The Tax Board compares the situation with a reversed

transfer of the parent's losses to the subsidiary and concludes, after reasoning very much in line with the M&S case, that EC law principles cannot be extended from the principles of the M&S case, which only comprised transfer of losses from foreign subsidiaries to a domestic parent. Some jurors (in minority) had dissenting views and concluded that there were no such principal hindrance against the deduction, but that it had not been shown that the Finnish parent in this case had extinguished all possibilities for utilizing its losses. In this case there were no references to the (similar) A-G's opinion in the *Oy AA (*formerly *Esab)* case (C-231/05) case, probably as it was presented prior to that opinion being issued.
-- Gunnar Andersson, Sweden; gunnar.andersson@se.pwc.com

Switzerland – Swiss parliament approves the revision protocol of the Swiss-Spanish Double Tax Treaty

In December 2006, the Swiss parliament has approved the revised protocol to the double tax treaty between Switzerland and Spain. The respective approval of the protocol by the Spanish parliament is expected to take place early 2007. The entry of the revised protocol into force (which will be three months after the exchange of the ratification documents) –and thereby also the applicability of art. 15 of the EU-Swiss Savings Tax Agreement (STA) with respect to Spain–is expected for mid- 2007.
-- Armin Marti and Anna-Maria Widrig.Giallouraki, Switzerland; armin.marti@ch.pwc.com

UK – Amendments to controlled foreign company rules following ECJ judgment in Cadbury Schweppes case

In overview, the UK CFC rules provide that where a UK resident company has an interest of 25% or more in a CFC, it must pay tax on an apportionment of the CFCs "chargeable profits" (broadly taxable profits computed on a UK basis, but excluding chargeable gains), with an effective credit for overseas tax paid. There is no such apportionment if one of several exemptions applies.

In its judgment of 12 September 2006 in the case of *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v CIR* (C196/04) the ECJ held that the UK CFC regime is *prima facie* contrary to the freedom of establishment provisions of the EC Treaty; but that the breach may be justified provided the regime applies only to "wholly artificial arrangements" which do not reflect genuine economic activity.

It was therefore announced in the Pre Budget Report on 6 December 2006 that the CFC rules are to be amended with effect from that date with a view to making them compliant with the ECJ judgment in the *Cadbury Schweppes* case. In particular:

Companies may apply to HMRC (the UK tax authority) to exclude from an apportionment of the CFC's chargeable profits an amount which represents the net economic value created by work carried out by individuals working for or at the direction of the CFC in business establishments within the CFC's EEA country of residence.

The 'exempt activities' exemption is to be amended such that a CFC resident in an EEA territory will only be regarded as effectively managed in that territory if there are sufficient individuals working for or at the direction of the company in the territory who have the competence and authority to undertake the company's business.

HMRC has published draft legislation and guidance notes and has invited comments by 28 February 2007.

However, it is strongly arguable that the proposed changes do not fully meet the requirements of the ECJ judgment in the *Cadbury Schweppes* case, since the judgment focuses on the existence of "genuine economic activity", whilst the proposed changes focus on the incremental group profit derived from activities undertaken by individuals working for the CFC in its business establishment(s), and ignore the contribution of capital and the EC Treaty right of nationals to transfer property intra-EU other than in an wholly artificial arrangement.
-- Chloe Paterson and Peter Cussons, United Kingdom; peter.cussons@uk.pwc.com

UK – Reduction in time limit for mistake of law claims

It was also announced in the Pre Budget Report on 6 December 2006 that the time limits for bringing an action for restitution of taxes paid under a mistake of law are to be further tightened following the House of Lords decision of 25 October 2006 in the case of *Deutsche Morgan Grenfell v Commissioners of Inland Revenue*.

Currently, the limitation period for bringing an action for restitution for amounts paid under a mistake of law is 6 years from the date the mistake was discovered. In the *Deutsche Morgan Grenfell* case it was held that where a taxpayer claimed repayment of tax paid under a mistake of law (in that case, not appreciating that a UK statutory provision was inconsistent with EU law), the mistake was discovered when the ECJ delivered its judgment, and the time limit therefore ran from the date of the ECJ judgment. However, the case was of limited impact as legislation had already been introduced to reduce the time limit for bringing action for restitution of direct taxes based upon mistake of law to six years from the date the tax was paid, although this only applied for actions brought on or after 8 September 2003.

Further legislation is now to be introduced such that the limitation period for an action involving a mistake of law will no longer apply in relation to a direct tax matter for actions bought before 8 September 2003, except where the claimant is subject to a final judgment given by the Courts before 6 December 2006. This means that the time limit will instead run from the date the tax was paid. The changes are presumably intended to limit the impact of the *Franked Investment Income Group Litigation* (the ECJ judgment was published shortly after the Pre Budget Report - see above). However, the change may itself not be compliant with EC Law as it does not provide for a transitional period for introduction of the new rules, and representations to this effect are being made to the UK Government and the European Commission.
-- Chloe Paterson and Peter Cussons, United Kingdom; peter.cussons@uk.pwc.com

Back to top

EU DEVELOPMENTS

Belgium – Commission requests Belgium to end discrimination against foreign charities

The European Commission has sent Belgium a formal request to end discrimination against foreign charities. Under Belgian tax legislation, donations to charities are tax deductible provided the charities are established in Belgium. The Commission argues that the condition that the charities are established in Belgium is contrary to the free movement of capital, guaranteed by Article 56 of the EC Treaty, which was confirmed by the ECJ in its judgement on the Stauffer case.

In reply to the letter of formal notice that the Commission sent earlier Belgium acknowledged the infringement, but it did not indicate when and how it would eliminate it, nor how it would apply EC Law in the period before the new rules would enter into force. The Commission therefore decided to move to the second stage of the infringement procedure.
-- Caroline Goemaere and Olivier Hermand, Belgium; olivier.hermand@pwc.be

EU – Commission unfolds new proposals for closer coordination of EU national direct tax systems, including exit taxes and cross-border loss relief

On 19 December 2006, the European Commission unfolded a new comprehensive proposal by means of a framework Communication for increased coordination of EU Member States' national direct tax systems in general and in two priority areas: cross-border loss relief and exit taxes. The proposed initiative runs parallel to the development of the Common Consolidated Corporate Tax Base (CCCTB). Through this initiative, the Commission hopes to give "fresh impetus" to:

- removing remaining discrimination and double taxation of taxpayers;
- protecting Member States' tax bases by preventing non-taxation and abuse; and
- reducing compliance costs for taxpayers subject to more than one tax system.

Due to the unanimity requirement in the Council (Art. 94 EC), there has been little harmonisation, and political cooperation assisted by the Commission has not led to progress. The Commission is increasingly concerned about the inability of "Europe" to respond effectively to pending important dossiers of common concern and new trends. For instance the sharp increase in litigation by taxpayers in national courts and the ECJ in recent years has reshaped the direct tax landscape in Europe. According to the Commission, this has resulted in a host of unilateral responses by Member States to individual ECJ decisions, which are either incompatible with the EC Treaty or with measures in force in other Member States, or with both. This is creating major difficulties from an EU (Internal Market) perspective and actually creates new obstacles.

The Commission holds that a failure to act now would impair Member States' ability to protect their tax revenues further and lead to more litigation on individual provisions. Given that full-scale harmonisation is not feasible now and the current trend undesirable, the Commission is pointing once more at the "soft law" format option of using, whereby non-binding approaches such as recommendations, best practice, mutual recognition and peer pressure replace legislative proposals. Coherent and coordinated solutions would thus be sought outside the Emus' institutional (legal) framework. A good earlier example of the "soft law" format is the EU-wide Code of Conduct against harmful tax competition.

Other areas selected for similar proposals in the course of the year under this coordination package are withholding taxes, anti-abuse measures, inheritance taxes and a general dispute resolution mechanism for double taxation.

The German Presidency, in charge of EU policies from 1 January until 1 July 2007, has already invited the Commission for initial discussions on 25 January.
-- Bob van der Made, The Netherlands; bob.van.der.made@nl.pwc.com

EU – Commission consults with business and academics on the CCCTB

On 12 and 13 December 2006, the CCCTB Working Group held its ninth meeting. The first day was used to consult with academics and representatives from the business sector and consisted of an all-day discussion on the working document prepared by the European Commission entitled: 'progress to date and future plans for the CCCTB'. The European Business Initiative on Taxation (EBIT), which is facilitated by PwC, was one of the pan-European business representations that were invited by the Commission and present on the first day (see also: EBIT Contribution to the Commission on the CCCTB). On the second day, the Working Group had its "standard" format i.e. with the participation of delegates from Member States. Click here for the latest EC update on the CCCTB.
-- Bob van der Made, The Netherlands; bob.van.der.made@nl.pwc.com

France – French fiscal economic interest groups (EIGs) constitute incompatible State aid

On 20 December 2006, the European Commission held that the French tax scheme for "fiscal economic interest groupings" (EIGs) constitutes incompatible State aid.

The French tax code provides (Art. 39C) that the tax deductible depreciation of assets leased by an EIG, a fiscally transparent structure, may not exceed the amount charged for the leasing operation. As an exception to this rule, financing operations involving assets depreciable over a period of more than 8 years, subject to ministerial approval (which was discretionarily granted), are not subject to the above restriction (Art. 39 CA CGI). In addition, the depreciation coefficient is increased by one point. Finally, if the assets are sold by the EIG to its user, the capital gains are tax exempt.

According to the Commission, these advantages clearly favour certain economic sectors, including transport, in which assets are used, which are depreciated over more than 8 years, such as ships, aircraft and trains. The users of the assets concerned, the members of the EIG, being mostly financial institutions, also benefit from the aid concerned as they receive a share of the tax advantages.

As France did not notify the scheme to the Commission as required, the Commission limited the recovery of the aid to aid granted after 31 April 2005 (i.e. the date on which the decision to open the formal investigation procedure was published). However, since January 2005, no ministerial approvals have been granted. A new regime has been introduced by the amended Finance Law for 2006.
-- Franck Le Mentec, France; franck.lementec@fr.landwellgobal.com

Switzerland – Extension of EU-Swiss Savings Tax Agreement to Bulgaria and Romania

Following the enlargement of the EU by Bulgaria and Romania per 1 January 2007, the EU-Swiss Savings Tax Agreement (STA) is automatically extended to these countries with the following main consequences:

- As from 1 January 2007, interest payments from Swiss paying agents (e.g. Swiss banks) to Romanian and Bulgarian resident individuals will be subject to retention of tax at source (currently at 15%), unless voluntary disclosure is chosen.
- As from 1 January 2007, dividend payments between Swiss and Bulgarian and Romanian companies will not be subject to withholding tax provided the general conditions of the STA are met. Therefore, the STA provides for a more beneficial treatment of cross-border dividends between Switzerland and these countries compared to that provided in the respective double tax treaties (the treaty withholding tax rate for substantial holdings being 5% for Bulgaria and 10% for Romania).
- As regards interest and royalty payments:
    - Bulgaria is allowed to levy withholding tax at maximum 10% until the end of 2010 and maximum 5% until the end of 2014
    - Romania is allowed to levy withholding tax at maximum 10% until the end of 2010.

During the transition period, royalty payments from these countries may benefit only from the respective Swiss double tax treaties providing for a full withholding tax relief (while interest payments are generally -subject to certain exceptions- subject to a 10% withholding tax also under the double tax treaties).
The above transitional provisions do not affect Switzerland as source State which based on domestic law does not levy withholding tax on royalty payments and on most intercompany interest payments.
-- Armin Marti and Anna-Maria Widrig Giallouraki, Switzerland; armin.marti@ch.pwc.com

Back to top

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 A-Gainst 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 .

For further information regarding the contents of this newsletter or the EUDTG in general, please contact the EUDTG Secretariat through Marcel Jakobsen (email: marcel.jakobsen@nl.pwc.com; tel.: + 31 10 407 5688).

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