EU Tax News

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ECJ CASES

Austria – ECJ judgment on Austrian taxation of dividends from third countries: Holböck case (C-157/05)

On 24 May 2007, the ECJ held that the Austrian taxation of dividends from third countries is grandfathered by Article 57(1) EC.

The claim was brought by Austrian resident Mr. Holböck regarding the taxation of dividends he received from a company established in a non-EU country (i.e. in Switzerland). Mr. Holböck held two thirds of the share capital in Swiss company and received dividends from this company in the years 1992 to 1996.

Under Austrian tax law as it was in those years, the taxation of dividend income in the hands of an Austrian resident individual varied according to whether the dividend was of Austrian or of foreign origin. With respect to domestic dividends, the taxpayer had the right to choose between a tax rate of 25% and half the average tax rate applicable to his total income. By contrast, dividends from a foreign company were taxed at the full progressive rates of income tax (i.e. up to 50%).

Referring to the purpose of the relevant legislation which was not intended to apply only where the shareholder has a definite influence on the company's decisions and activities, the ECJ held that the case should be considered under both Article 43 (freedom of establishment) and Article 56 EC (free movement of capital)

Since the freedom of establishment does not apply vis-à-vis third countries, the ECJ went on to consider the principle of free movement of capital. Under the "Stand-Still-Clause" of Article 57(1), Member States have the right to retain national restrictions for certain types of capital movements in relation to non-EU countries, provided that those restrictions were in force at the end of 1993. The ECJ held that dividend payments relating to holdings acquired with a view to establishing or maintaining lasting and direct economic links between the shareholder and the company, and which allow the shareholder to participate effectively in the management or control of the company, are to be regarded as a type of capital movement covered by Article 57(1). Furthermore, the ECJ regarded the national rule as in force at the end of 1993, as amendments to that rule after that time were of a minor nature. See also EUDTG Newsalert NA 2007 – 016.

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Finland – ECJ referral on Finnish withholding taxation on dividends paid by a Finnish company to a Luxembourg SICAV

On 27 June 2007, the Finnish Supreme Administrative Court filed a request for a preliminary ruling to the ECJ with respect to withholding taxation of Finnish source dividends to a Luxembourg SICAV.

The Luxembourg resident N SICAV holds 100% of the shares in a Finnish resident A Oy (limited liability company) which has plans to invest in real estate around Scandinavia. The shares in N SICAV will be primarily offered to institutional investors in Germany, such as insurance companies and pension funds, but also to other European investors. A Oy will invest in real estate either by acquiring shares in real estate companies or by investing directly in real estate. According to the background information, N SICAV is not an investment fund as mentioned in Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS).

The Court referred the following question for a preliminary ruling to the ECJ (unofficial translation):

"Should the EC Treaty articles 43 and 48 as well as 56 and 58 be interpreted in such a way that the basic freedoms provided by them require a Finnish limited liability company or an investment fund be considered to be comparable to a Luxembourg SICAV even though a company form corresponding to a Luxemburg SICAV does not exist in Finland, while at the same time considering that a Luxembourg SICAV, which is a company according to Luxembourg legislation, is not mentioned in the appendix referred to in the Parent Subsidiary Directive Article 2(a), and that the Finnish domestic legislation is in accordance with the said Directive as well as the Luxembourg SICAV being income tax exempt in Luxembourg? Thus, is it therefore a breach of the aforementioned EC Treaty articles, that the Luxembourg SICAV as a recipient of Finnish source dividend is not exempt from withholding taxation in Finland?"

-- Jarno Laaksonen and Heidi Katajainen, Finland; jarno.laaksonen@fi.pwc.com

Germany – A-G Opinion on German State granted subsidy for self-occupied houses in Germany: Commission v Germany (C-152/05)

On 28 June 2007, A-G Bot opined that Germany has failed to fulfil its obligations under Articles 39 and 43 EC by excluding persons subject to unlimited taxation that own self-occupied homes in other Member States from the subsidy for self-occupied houses.

Since 1996, housing grants are available under German rules ("Eigenheimzulagegesetz") for the construction or for the acquisition of personal accommodation under two main conditions: The applicant must be subject to unlimited German tax liability and the house must be situated in Germany. That means that persons - although subject to unlimited tax liability - who live outside Germany and want to acquire a property there do not benefit from the home allowance. Through the second requirement basically three groups of people who are subject to extended unlimited tax liability in Germany could be discriminated against:

- state employees who are resident in another Member State
- cross-border workers who earn at least 90 % of their income in Germany, and
- diplomats and EU officials from Germany.

On 5 April 2005, the European Commission decided to refer Germany to the ECJ because of these provisions on housing grants as it considered them to be infringing the freedom of movement (Article 18 EC), the freedom of movement of workers (Article 39 EC), and the freedom of establishment (Article 43 EC).

The German Government had essentially asserted two arguments: At first, they claimed that the provisions were not discriminatory, as a German resident taxpayer would not be granted the subsidy either if he purchases or builds a house outside Germany. Secondly, the obstacle - if there was any - should at least be justified by the purpose of the restriction, namely to improve the housing space situation as a matter of public interest.

A-G Bot rejected the German reasoning. He points out that the rules in question decrease the attractiveness for state employees to take up employment in another Member State. In addition, cross-border activities of both employees (Article 39 EC) and self-employed persons (Article 43 EC) are treated disadvantageously. Therefore, the German provisions are in breach of Articles 39 EC and 43 EC.

The A-G then principally accepts the legislation's aim of improving the housing space situation in Germany as a justification ground but considers this measure to be disproportionate: if the subsidy would be granted for the construction or acquisition of houses in other Member States as well, this would likewise improve the housing space situation in Germany, since the demand on the German real estate market would be decreased.

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Germany – ECJ order on the applicability of Article 56 EC to German thin cap rules: Lasertec case (C-492/04)

On 10 May 2007, the ECJ ruled that Article 56 EC does not apply to the German thin cap rules.

The applicant (Lasertec Gesellschaft für Stanzformen GmbH is a German resident company whose shares were held as to 67 % by the Swiss resident Lasertec AG. Applying the German thin cap rules, the Tax Authorities reclassified loan interest charges paid by the applicant to Lasertec AG as a constructive dividend distribution and taxed them accordingly. As the shareholder is a Swiss company, the applicant claimed a restriction on the free movement of capital, the only fundamental freedom applying to third country residents.

The ECJ stated that in order to ascertain whether national legislation falls under one or the other fundamental freedom, the *purpose of the legislation at issue* is decisive. Thus, national provisions relating to holdings that give the shareholder a definite influence on the decisions of the company concerned and allow him to determine its activities fall within the scope of Article 43 EC exclusively and consequently cannot be considered under the movement of capital even in third country cases. As the provision at issue requires a "substantial holding" amounting to at least 25 % of the

nominal capital or an otherwise dominant influence by the lending company, the case falls within the material scope solely of Article 43 EC

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Germany – ECJ referral on German requirement of book value attribution in cross-border exchange of shares: Ernst & Young case (C-285/07)

On 7 March 2007, the German Supreme Tax Court asked the ECJ for a preliminary ruling on the compatibility of the German rules on taxation of cross-border exchange of shares with either the Merger Directive or the Articles 43 and 56 EC.

In the case at hand, a German AG (transferring company) was shareholder of a German GmbH. In 2000, the AG transferred the GmbH shares to a French S.A. (acquiring company) in exchange for new shares in the S.A, which it capitalised at the same book value as the former GmbH shares. The French S.A. capitalised the shares in the GmbH at market value for book and for tax purposes. Due to this, the German tax authorities taxed the difference between book and market value of the GmbH shares as capital gain for the German AG. After court proceedings, the German Supreme Tax Court referred the case to the ECJ for the following reasons:

For a domestic or cross-border share exchange to be tax neutral for the transferring company, the German Restructuring Tax Act e.g. requires that the acquiring company capitalises the transferred shares at book value. If the acquiring company attributes to these shares a higher value, the transferring company is taxed with a capital gain. The taxation of the transferring company is thus linked to the acquiring company's evaluation of the shares.

The requirement of book value attribution in the acquiring company for the transaction to be tax neutral for the transferring company could be in breach of Article 8 (2) of the EU Merger Directive 90/434/EEC as well as of the freedom of establishment and free movement of capital: Article 8 para. 1 of the Directive states that the allotment of shares in the acquiring company to the transferring company in a share exchange shall not give rise to any taxation of the income, profits or capital gains of the transferring company. Article 8 (2) makes this conditional upon the transferring company not attributing to the received shares in the acquiring company a higher value than the exchanged shares had before the transaction. The Directive is silent on the value attribution in the acquiring company. The Court does therefore not consider Article 8 (2) to be immediately applicable, since it is not sufficiently clear and precise enough to rely upon and leaves room for own decision by the Member States. Due to the fact that Article 8 (2) only deals with the transferring company, the Member States could indeed be free to introduce its own rules for the acquiring company. The Court nonetheless posed the question of a potential breach of the Directive to the ECJ.

If Article 8 (2) of the Directive does not preclude the book value requirement in the acquiring company, it might still be in breach of Article 43 and 56 EC. The German legislator introduced the necessity of a link between the acquiring company's value attribution and the capital gains taxation

in the transferring company mainly for domestic purposes. However, should such a link not be required in cross-border cases, these would be treated better than domestic ones. The fundamental freedoms in the EC Treaty contain a prohibition of discriminatory measures as well as restrictions (equally applicable measures). It is for the ECJ to decide how these two inter-relate, on the one hand considering that the German principle applies both domestically and cross-border and on the other hand considering that in a domestic case, the acquiring company is subject to German and in a cross-border case, to the tax laws of another Member State.

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Germany - Referral to the ECJ on non-deductibility of donations in kind to foreign charities: Persche case (C-318/07)

A German resident person donated items to a value of 18,180 EURO to a Portuguese nursing home and deducted this in his German tax return. The nursing home was approved as an institution for social solidarity according to Portuguese law. The tax deduction was denied in Germany.

In Germany, donation to charities, including donations in kind, are to a certain amount tax deductible for the donator. The deductibility is dependant on that the recipient is a domestic public corporation / agency or a tax exempt corporation. Only corporations with seat or place of management in Germany are tax exempt. To qualify as a charity, certain requirements on the bylaws and management have to be met. The fulfilment of these is controlled in tax audits of domestic charities. Donations to such charities are only tax deductible if the recipient issues verification on an official form.

On 9 May 2007, the German Federal Tax Court referred three questions to the ECJ regarding these rules.

Firstly, it questioned if donations are covered by Article 56 EC, since the free movement of capital protects capital *investments*: Donations in cash or kind are not *investments*. On the other hand, the Directive 88/361/EEC includes gifts and endowments as personal capital movements (XI B nomenclature).

Secondly, if donations are covered by Article 56 EC, are the German rules in breach of this Article? Legally, charities must promote the interest of the general public. Contrary to what the ECJ stated in the Stauffer case (C-386/04, see EUDTG Newsalert NA 2006 - 025), it is controversial whether the general public consists of inhabitants and citizens of Germany or also includes foreign populations. Moreover, fiscal supervision is necessary to avoid an execution deficiency in collecting taxes, leading to an unconstitutional taxation. The ECJ regularly states that the Mutual Assistance Directive is a sufficient means for fiscal supervision. However, a substantial assessment of whether the requirements for a tax-exempt charity are met is regularly only possible in a tax audit. Mutual assistance is therefore only sufficient for fiscal supervision if foreign tax authorities are obliged to carry out tax audits similar to German ones. It is doubtful if the Directive

contains such obligation, since *assistance* from a foreign tax authority cannot imply that it must carry out complete audits on behalf of another country. Even if such assistance were possible, it would infringe the proportionality principle if every donor could require a foreign tax audit in order for him/her to deduct a donation. Tax authorities are further allowed to deny assistance, where the benefit obtained is not proportionate to the time and effort. However, the German tax authorities cannot refrain from such verifications, as fiscal control is an acceptable justification for restrictions of the fundamental freedoms. The Court thus considers the limitation of tax deductibility only to donations to domestic institutions not to be a breach of Article 56 EC.

Thirdly, if the ECJ considers the limitation to be a breach of Article 56, the Court asks about the extent of evidence to be produced: According to German law, tax authorities may require from taxpayers all information necessary (here: to decide on the charitable status of the foreign institution). If sufficient information cannot be provided, deductions may be denied. The Court asks if it is sufficient for the tax authorities to require information from the taxpayer, as German law stipulates, or if they are obliged under EC Law to collect this from other Member States through mutual assistance.

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Italy – A-G Opinion on Italian taxation of EU aid contributions: Porto Antico di Genova case (C-427/05)

On 8 May 2007, A-G Mazák delivered his Opinion in the Porto Antico di Genova case stating that the Italian tax provisions, under which any financial contributions (including those granted as part of the EU's funding programmes) are subject to national income tax, are compatible with Article 21(3) of Council Regulation (EEC) no. 4253/88 (as amended by Council Regulation (EEC) no. 2082/93). The second paragraph of the mentioned Article establishes that the payments of EC contributions "shall be made to the final beneficiaries without any deduction or retention which could reduce the amount of financial assistance to which they are entitled".

In the case at hand, an Italian company, Porto Antico di Genova S.p.A., received from the European Regional Development Fund (ERDF) a financial contribution paid partly by EU bodies and partly by domestic regional entities. According to the Italian tax legislation, this contribution must be taken into account for the purposes of determining the taxable income and, therefore, it is subject to income tax. The company, considering that the taxation on the financial contribution has the effect of reducing the total amount, applied for the reimbursement of the income tax paid on the financial aid.

The A-G held that, in the present case, even if it is possible to calculate the amount of the income tax paid on the financial aid received, the subjection to corporate income tax of the EC contributions cannot be considered a deduction directly and inseparably linked to the contribution received as the payment of the contribution was not conditional upon it being subsequently taken into account for the purposes of determining the taxable income. The A-G admits that direct taxes

like that at issue have the effect of reducing the amount of the aid received but, concludes that their application is not prohibited by Article 21(3). See also EU Tax News Issue 2006 - nr. 004.

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Netherlands – A-G Opinion on Dutch withholding tax treatment of outbound dividends: Amurta case (C-379/05)

On 7 June, A-G Mengozzi opined that the Dutch differential withholding tax treatment of outbound dividends compared to that of domestic dividends is in breach of Article 56 EC.

In 2002, Retailbox B.V., a company incorporated under Dutch law and resident for tax purposes in the Netherlands, paid a dividend to Amurta S.G.P.S., a company incorporated under Portuguese law and resident for tax purposes in Portugal, net of dividend withholding tax paid at the statutory rate of 25 per cent. The exemption from withholding tax provided for in the Parent-Subsidiary Directive was not applicable, as Amurta owned less than 25 per cent in the capital of Retailbox. Accordingly Amurta appealed to the Court of Appeal of Amsterdam, arguing that the payment of dividend withholding tax constituted a discriminatory restriction on the free movement of capital prohibited by Article 56 of the EC Treaty, as dividends paid on shares qualifying for the participation exemption and owned by companies that either are resident for tax purposes in the Netherlands or carry on business in the Netherlands through a permanent establishment are exempt from both dividend withholding tax and corporation tax. The case was referred to the ECJ for a preliminary ruling.

The A-G considered that a different treatment of dividends paid by a company resident for tax purposes in the Netherlands according to whether or not the shareholders of that company are resident for tax purposes in Netherlands as well, constitutes an arbitrary discrimination, as the situation of corporate shareholders resident for tax purposes in the Netherlands and those resident for tax purposes in another Member State are objectively comparable, taking into account the object and purpose of the legislation in question, i.e. the avoidance of economic double taxation on company profits. Accordingly, he concluded that the exemption from dividend withholding tax provided for by the legislation in question, which applies only to dividends paid to companies that are either resident in the Netherlands for tax purposes or carry on business in the Netherlands through a permanent establishment, is not compatible with Article 56 EC.

Additionally, the A-G observed that, according to Amurta, the dividend received from Retailbox is exempt from corporation tax in Portugal and any withholding tax paid on the dividend in the Netherlands cannot, therefore, be credited against Portuguese corporation tax. Even if the withholding tax paid in the Netherlands could be credited in full against Portuguese corporation tax, which is for the national court to determine, this would, according to the A-G, be totally irrelevant if the credit is granted by Portugal unilaterally. See also EUDTG Newsalert NA 2007 – 017.

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Sweden – ECJ order on compatibility with EC Law of Swedish legislation on dividend tax relief in relations with third countries: Skatteverket v. A and B case (C-102/05)

On 10 May 2007, the ECJ ruled in the case of Skatteverket v. A and B by reasoned order. In the case at hand Swedish tax rules on closely-held companies led to less favourable taxation of dividends for shareholders of a Swedish company due to the fact that the company had a permanent establishment in a third state, namely Russia, and not in Sweden. The preliminary questions raised by the Swedish Supreme Administrative Court to the ECJ concerned whether the Swedish rules are contrary to the freedom of capital within the meaning of Articles 56 and 58 EC. The ECJ concluded that the Swedish rules seriously restrict the freedom of establishment within the meaning of Article 43 EC. The freedom of establishment cannot, however, be invoked with respect to establishments in a third country.

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NATIONAL DEVELOPMENTS

Estonia - Administrative Court decision on dividend payments to EU investment funds

On 10 May 2007, The Tallinn Administrative Court concluded that - as the court of first instance - it has no obligation to refer the case to ECJ and it also considered the Estonian Income Tax Act to be compatible with the EC Treaty with regard to the taxation of dividend payments to EU investment funds

In the case at hand, an investment fund (UCITS) established under Luxembourg laws as a legal entity (SICAV), owned shares in an Estonian resident corporation. Dividends distributed to a non-resident having a less than 20% participation in an Estonian legal entity were subject to a withholding tax. The fund claimed that the situation where tax was withheld from dividends paid to a foreign investment fund was a violation of Articles 56 and 58 EC because there was no tax withheld from dividends paid to domestic UCITS.

The Court stated that the foreign fund established as a legal entity should be compared to an Estonian legal entity in similar circumstances. The fact that in Estonia UCITS can only be established as a pool of assets (i.e. not a legal entity) does not provide grounds for comparing the foreign UCITS with Estonian UCITS. The Court found that the comparison between residents and non-residents can only be made on the basis of their formal legal status.

Resident legal entities in Estonia are subject to corporate income tax at the moment the profits are distributed. Economic double taxation in a domestic situation is only avoided if a parent has at least a 20% participation in another company. The Court found that both resident and non-resident legal entities suffer economic double taxation if their participation in an Estonian company is less than 20% and they are therefore equally treated.

The Court considered that the timing difference resulting from taxation of non-resident entities by withholding, but allowing resident corporations to defer the tax charge until they make further distributions out of the dividends received can be justified by the coherence of the Estonian tax system and the necessity to guarantee the effectiveness of fiscal supervision. The case has been appealed to the district court.

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France – New guidelines for French dividend withholding tax after the ECJ judgment in the Denkavit case

In order to ensure compliance with the ECJ's Denkavit decision (C-170/05) of 12 December 2006, the French Tax Authorities issued new guidelines on 10 May 2007 (BOI 4 C-7-07) regarding the tax treatment of dividends paid from French subsidiaries to EU parent companies or parent companies which are resident in an EEA state and which have concluded a tax treaty with France containing an administrative assistance clause.

In the absence of any "artificial scheme", French source dividends will not be subject to any withholding tax in France, where the foreign parent company has a stake higher than 5%, and provided it cannot offset the French withholding tax according to its own local legislation

According to the French tax authorities, this new withholding tax exemption applies as from 1 January 2007.

We are of the opinion that a claim for refund can nevertheless be filed up to 31 December 2008 in respect of withholding taxes paid in France as from 1 January 2003. See also EUDTG Newsalert NA 2007 – 018.

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Germany – Ministry of Finance decree on German withholding tax for certain income of non-resident taxpayers after the ECJ judgment in the Scorpio case (C-290-04)

On 3 October 2006, the ECJ handed down its judgement in the FKP Scorpio Konzertproduktionen GmbH case (see EU Tax News Issue Issue 2006 - nr. 006 and EUDTG Newsalert NA 2006 - 028) regarding the German tax at source on certain income of non-residents.

The ECJ stated that the withholding tax for non-resident service providers as well as the liability of the recipient of services (as a debtor) are not in breach of Article 49 EC (freedom to provide services). The ECJ held that these special provisions in cases of non-resident providers are infringements of the freedom to provide services. However, these obstacles are justified in the year in question (1993) due to the necessity to secure the taxation of non-residents - insofar the measures are also proportionate: Since in 1993, neither EC Law nor the tax treaty in question provided means for Germany to recover taxes in the state of residence of the service provider.

Therefore, it is unclear if these measures are still justified after the implementation of the EU Directive 2001/44/EC on Mutual Assistance in 2002 respectively where the tax treaty contains a clause on mutual recovery of claims.

Further, the ECJ found that it is in breach of Article 49 EG if expenses which are directly economically linked to the German income are not deducted immediately on the source level, but in a subsequent claim. Otherwise, in respect of expenses without a direct link to the income it is sufficient if these expenses are taken into account in a subsequent refund procedure.

Finally, the requirement of an exemption certificate in order to benefit from a tax treaty zero rate in Germany is an infringement that is justified by the necessity to ensure the proper functioning of the source taxation. As it is questionable if the source taxation in itself is still justified, it is as well problematic if the German tax authorities yet demand an exemption certificate.

On 5 April 2007, the German Ministry of Finance (BMF) issued a decree intended to apply the principles of the Scorpio decision until the corresponding German tax legislation is adjusted. The decree is not restricted to the taxation of non-resident service providers, but rather concerns withholding taxes on all type of income of non-resident artists, sportsmen and related services.

At first, the BMF states that according to the judgment the withholding tax for non-residents, the liability of the debtor and the requirement of the exemption certificate are not in breach of EC Law. Unfortunately, the decree doesn't deal with the question of whether the Court's statements in the Scorpio ruling are still valid after the changes in the area of mutual assistance.

Secondly, the BMF basically accepts the deduction of expenses which are directly economically linked to the German income already in the withholding procedure. Still, for the deduction at source level an additional requirement must be fulfilled: The expenses should only be subtracted if they exceed 50 % of the particular income. The BMF claims that expenses of 50 % have already been taken into consideration across-the-board in the flat tax rate of 20 % - the legislator should have presumed an underlying average net tax rate of 40 %.

However, it can be argued that this reasoning is rather doubtful. First of all, the alleged tax rate of 40 % cannot be found in the German tax law. Secondly, the ECJ repeatedly stated that a flat tax for non-residents is inconsistent with the fundamental freedoms as far as the effective tax burden of residents is exceeded. A net tax rate of 40 % yet rarely applies for German resident individuals; for German resident corporations, however, the net tax rate is only 25 % and will presumably even be lowered to 15 % in the course of the current tax reform process.

In addition, in its judgement Centro Equestre (see EU Tax News Issue 2007 – nr. 002 and EUDTG Newsalert NA 2007 – 006) the ECJ recently held that the German provisions are incompatible with the freedom to provide services as far as they make the repayment of the tax to a non-resident taxpayer subject to the condition that the operating expenses exceed half of the income.

Furthermore, according to the decree, only expenses that are *already paid* and which are *proved* to the tax authorities should be deducted - whereas the ECJ speaks of expenses '*reported*' from the service provider to the debtor. Therefore, the ECJ appears to set lower requirements for the deduction within the withholding procedure - in particular the subtraction of *future* costs could be possible due to the ruling. Moreover, resident taxpayers only need to *substantiate* expenses in order to have them deducted for the purpose of assessing tax prepayments, while non-residents, must *prove* the expenses, so the BMF therefore seems to be prolonging their discriminatory treatment.

It remains doubtful whether the German treatment of certain non-resident service providers is in accordance with EC Law. Following the ECJ judgements on Scorpio and Centro Equestre, the European Commission carried out an infringement procedure against Germany regarding the discrimination of the non-resident taxpayers (see EU Tax News Issue 2007 – nr. 003). Hence, it will be revealing to see if the Commission continues with the infringement procedure after the release of the decree at hand.

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Germany – Ministry of Finance decree on write-downs of foreign participations after the judgement in the Rewe-Zentralfinanz case (C-347/04)

The ECJ rendered its judgement concerning write-downs on certain 'passive' foreign participations in the Rewe-Zentralfinanz case on 29 March 2007 (see EU Tax News Issue 2007 – nr. 003 and EUDTG Newsalert NA 2007 - 013).

The ECJ held that the German provisions are inconsistent with the freedom of establishment (Article 43 EC) as parent companies with subsidiaries in other Member States deemed as 'passive' are treated unfavourably compared to parent companies with German subsidiaries. Indeed, losses stemming from write-downs of shares in non-resident subsidiaries could be set off against future profits relating to those shares. Though, as losses deriving from a German subsidiary could be deducted immediately, the relevant provision resulted (at least) in a cash-flow disadvantage.

As a reaction to this ruling, the German Ministry of Finance (BMF) released a decree on 11 April 2007, in which it states that the relevant provision prohibiting the tax deduction on certain write-downs on foreign participations, basically must not be applied any further on negative income with reference to EU or EEA Member States. However, two exceptions are made: Liechtenstein is excluded from this rule since it does not provide mutual assistance, and secondly, write-downs on foreign participations are still restricted in their deductibility if these write-downs are based upon circumstances beyond the EU or EEA area. Particularly the second exclusion is rather vague. It remains to be seen how this requirement will be interpreted by the German tax authorities.

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Italy – Repeal of the 1998 Italian provisions concerning the 1985-1992 administrative charge due to the registration of corporate documents

In 1993 the ECJ gave its judgment in the *Ponente Carni* case (joined cases C-71/91 and C-178/91), establishing that the Italian rules on the administrative charge were incompatible with the EU Directive 69/335/EEC concerning indirect taxes on the raising of capital. In fact, this charge could not be considered as a duty paid by way of fees calculated on the basis of the service rendered (the keeping of the register of companies) allowed by the same Directive. Consequently, in the same year Italy decided to amend the previous legislation, by introducing a new charge to be paid for the registration of the articles of association and in the case of the registration of every subsequent document from the incorporation of the company.

By Law no. 448 of 1998, a new administrative charge was introduced having retroactive effects for the years 1985-1992 and a reimbursement was allowed of up to the difference between the new charge and that one paid by the companies in the same period in accordance with the previous legislation. The Law also fixed at 2.5% the interest rate on the amounts reimbursed (the rate was considerably lower than that one applied for the refund of other taxes) and established that, according to the Italian legislation concerning the reimbursement of the administrative charges, the request for a refund had to be filed within three years from the date of payment.

As reported in EU Tax News Issue 2006 - nr. 004, on 11 May 2006, the ECJ issued its decision in the *Commission v Italy* case (C-197/03), ruling that the charge introduced in 1998 was levied in addition to similar charges already paid in the years 1985-1992 because, on the basis of the temporal limitation to file the refund claims, the latter could not be reimbursed to the companies. Consequently, the ECJ concluded that the new charge does not constitute a fee linked to the service rendered and therefore it is not in line with the Directive. It also ruled that the interest rate on the amount refunded cannot be lower that the rate applied for the refund of other taxes.

In accordance with the above-mentioned case-law, the Italian Parliament, by means of Law no. 46 of 2007, repealed the rules on the administrative charge provided for by Law no 448 of 1998. The same Law also established the reimbursement of the total amount of the charges paid by companies in the years 1985-1992 and fixed the interest rate at the same level of the interest rate applied for the refund of other taxes. As the provision concerning the temporal limitation of the request for the refund has not been amended, the claim had to be filed within three years from the date of payment.

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Italy – Italian Tax Authorities' Resolution on the application of Article 15 of the 2004 Agreement between the EU and Switzerland

On 10 May 2007, the Italian Tax Authorities issued Resolution no. 93/E which clarifies the scope of Article 15 of the 2004 Agreement between the European Communities and the Swiss Confederation on taxation of savings.

Article 15 (1) states that dividend distributions between EU and Swiss companies are not subject to taxation in the source State if the following conditions are met:

- the parent company holds at least 25% of the stock of its subsidiary for at least two years; and
- one company is resident for tax purposes in a Member State and the other one is resident for tax purposes in Switzerland; and
- neither company is resident for tax purposes in a third State on the basis of any applicable double taxation treaty; and
- both companies are subject to corporation tax without exemption and adopt the form of a limited company under national law.

The Italian Tax Authorities affirm that the withholding tax exemption on dividends distributed by an Italian subsidiary to a Swiss parent company is applicable only if the latter is fully subject to federal, cantonal and municipal taxes in Switzerland.

In this respect, they refer to the European Commission's Decision issued on 13 February 2007, which ruled that certain Swiss tax regimes exempting fully or partially from cantonal and municipal taxes Swiss companies' profits generated in the EU are incompatible with the proper functioning of the trade relations between the EU and Switzerland.

The approach of the Italian Tax Authorities seems to be in contrast with the EC Treaty, also taking into account the A-G Mengozzi Opinion, delivered on 29 March 2007 in the *Columbus Container Services* case (C-298/05; see also EUDTG Newsalert NA 2007 - 014). The A-G stated that "*the fact that a controversial tax regime can be considered as State aid incompatible with the common market, whose control is, under the Treaty, attributed to the Commission, cannot entitle a Member State to adopt unilateral measures against this regime in order to contrast its effects*". With this statement, the A-G essentially affirmed that the EC Treaty assigns to the Commission the exclusive power to adopt defensive measures in the presence of favourable tax regimes.

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Netherlands – A-G Opinions on tax sparing credits and most favoured nation treatment

On 5 July 2007, A-G Wattel delivered his opinions in cases 43507, 43619 and 43777. These cases concerned corporate taxpayers, resident in the Netherlands, receiving dividends, interest and royalties from both EU and non-EU resident companies. The taxpayers argued that a tax sparing credit should be granted with respect to these payments, as a tax sparing credit would have been available under Dutch tax treaties if the payments would have been made by a resident of Brazil of Greece. A differential treatment of payments to a Netherlands resident company on the basis of the place of residence of the company making the payment constitutes a restriction on the free movement of capital, the taxpayers argued. According to A-G Wattel, however, the differential treatment is not contrary to EC Law. He is of the opinion that the ECJ has already decided that EC

Law does not require most favoured nation treatment (cases C-376/03 *D* and C-374/04 *Test Claimants in Class IV of the ACT Group Litigation*). He advises the Dutch Supreme Court to dismiss the appeal of the taxpayers.

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Netherlands – A-G Opinion: method of ordinary credit not contrary to EC Law

On 5 July 2007, the Dutch A-G Wattel delivered his opinion in case 43619. This case concerned a Dutch N.V. receiving dividends, interest and royalties from both EU and non-EU resident companies. These payments have been subject to a withholding tax at source. Both unilaterally and under its tax treaties, the Netherlands eliminates international juridical double taxation by applying the method of 'ordinary credit'. This means that the Netherlands allows a deduction from its own tax for the tax paid in the other State. This deduction is restricted, however, to that part of Netherlands tax which is appropriate to the foreign income. As a result, not all withholding taxes could be deducted in the taxable year concerned. The taxpayer argued that this amounts to a restriction on freedom of establishment and free movement of capital. According to the A-G, however, the method of 'ordinary credit' is not contrary to Community law. He is of the opinion that the ECJ has already decided that EC Law does not require that the residence State eliminate international juridical or economic double taxation beyond its own tax atributable to the income (cases C-336/96 *Gilly* and C-446/04 *Test Claimants in the Franked Investment Income Group Litigation*). He advises the Dutch Supreme Court to dismiss the appeal of the taxpayer.

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UK – Marks & Spencer plc v Halsey: House of Lords refuse HMRC leave to appeal

The UK's Supreme Court (House of Lords) has refused HMRC leave to appeal against the Court of Appeal's 20 February 2007 judgment in the Marks & Spencer cross border loss relief case. The Court of Appeal held that the test (set out in the ECJ's judgment of 13 December 2005) as to whether all possibilities of utilising the losses overseas both in the past and in the future have been exhausted must be applied at the date when the final group relief claim is made. Accordingly the Court of Appeal's decision is now final. However, the case has been referred back to the Special Commissioners to determine questions of fact. After M&S itself has had its appeal determined by the Special Commissioners, other claimants will be able to proceed towards agreement of their claims.

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UK – Boake Allen Limited and others v HMRC: House of Lords judgment in ACT Class 3 group litigation

In 2001, the ECJ decided in the Hoechst case that the inability of a UK subsidiary to enter into a 'group income election' with its EU parent (where such an election could have been entered into with a UK parent company), such that advance corporation tax (ACT) was payable on dividends to

EU parents (but not on dividends to UK parents), was contrary to the freedom of establishment provisions of the EC Treaty.

The UK claimants in the ACT Class 3 group litigation (of which Boake Allen is a test claimant) were effectively trying to extend the Hoechst principle to UK subsidiaries with third country (i.e. non-EU) parent companies. They argued that the levying of ACT on dividends paid to non-EU parent companies is in breach of the non-discrimination article of the relevant bilateral double taxation treaty, and in breach of Article 56 (free movement of capital and payments) of the EC Treaty. The House of Lords (the UK Supreme Court) delivered its judgment on 23 May 2007.

The Lords concluded that the inability to make a group income election with a non-UK parent company was not on the ground of the UK subsidiary's foreign control, but on the ground that a group income election cannot be applied to a case in which the parent company is not liable to ACT, and thus that the UK provisions were not contrary to the non-discrimination articles of double tax treaties. Two of the five Lords went on to opine that, even if the UK provisions had been contrary to the non-discrimination article of bilateral treaties, there would still be no remedy, as the treaties had not been incorporated into domestic law as regards ACT.

In addition, the Lords held that even if the provisions in question constituted a restriction on the movement of capital and payments in accordance with Article 56, since the provisions in question were in place before 31 December 1993, Article 57 disapplied the application of Article 56.

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UK – Taxation of foreign profits: Consultation

On 21 June 2007 the UK Government published a discussion document on the UK taxation of the foreign profits of companies. Changes to the current UK rules are proposed to increase the UK's international competitiveness, but also in response to recent ECJ decisions concerning the compatibility of UK legislation with European law, such as the *Franked Investment Income Group Litigation* which was concerned with the differential UK corporation tax treatment of UK and EU dividends, and the *Cadbury Schweppes* case which considered the UK CFC regime.

Proposals include an exemption regime for most foreign dividends for large and medium businesses and a simplified credit regime for small businesses; a new Controlled Companies regime to apply to UK and foreign companies to replace the current controlled foreign company (CFC) rules; replacement of the Treasury Consents rules with an information-reporting requirement; and restrictions on the net amount of interest claimed by UK members of multinational groups by reference to the group's total consolidated net finance costs. The discussion document also explores options for the future taxation of portfolio dividends in light of the ECJ decision in the Franked Investment Income GLO. The deadline for responses is 14 September 2007 and the aim is for changes to become law in 2009, although the precise timing has not been confirmed.

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UK – Overseas leasing

For leases entered into before 1 April 2006, UK legislation provided that expenditure incurred on the provision of plant and machinery for leasing qualified for capital allowances (tax depreciation) at a rate of 25% per annum. However, for plant and machinery used for overseas leasing, then capital allowances were restricted to 10%.

HMRC has now conceded that, in some circumstances these rules may be contrary to EU law. HMRC will therefore not contest certain claims for capital allowances where the lessee is resident in an EEA territory. Where that territory gives the lessee a relief broadly equivalent to capital allowances, the lessor will qualify for UK capital allowances, subject to the 10% rate restriction. In other cases the lessor will qualify for UK capital allowances at the full 25% rate.

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EU DEVELOPMENTS

Hungary – Update on European Commission's infringement proceeding against Hungary regarding its intra-group interest taxation scheme

As reported in EUDTG Newsalert NA 2007 - 010), the European Commission has started an infringement procedure against Hungary regarding the Hungarian intra-group interest taxation scheme, investigating whether it qualifies as prohibited state aid. According to the EC Treaty, state aid is any aid granted by the Member State or provided from State resources, in any form, which distorts or threatens competition by favouring certain undertakings or certain goods, and which affects the trade between Member States.

The Hungarian Government has recently submitted a position paper to the Commission stating that the intra-group interest taxation scheme cannot be classified as prohibited state aid for the following reasons.

1) The intra-group interest taxation scheme is a narrow form of group taxation (restricted to the field of financing). Group taxation is a commonly accepted scheme in a number of EU Member States and as such is EU compliant.

2) The scheme does not provide advantages in a domestic situation since the borrower increases its taxable base with an amount equal to the tax deduction available for the lender. The intra-group interest taxation scheme only confers potential advantages if the related parties are of different nationalities and the foreign law allows full deduction of interest costs as opposed to the 50% deduction under domestic law. Hungary, however, cannot influence foreign tax laws. In addition, on the basis of ECJ case law in the field of

direct taxation, the difference between the tax systems of the Member States must be acknowledged.

3) Regarding the argument that certain types of tax payers are excluded from the scheme, Hungary explained that in the case of SME it is not realistic to expect an SME to form and finance a multinational group. In the case of financial institutions, the financing of independent parties will in any case be a banking activity, requiring a banking licence. In addition, financial institutions are normally subject to specific regulations, and therefore excluding them does not distort competition. Related parties may not be seen as a restriction since regular financing outside a group qualifies as a banking activity.

4) Finally, the EU requested and received information regarding the scheme in 2004, therefore, should it be a state aid, it should qualify as an existing state aid. Thus, it will have no adverse effect on Hungarian enterprises (i.e.: they will not likely incur a repayment obligation).

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Italy – European Commission investigates Italian tax incentive regarding the recognition of hidden capital gains of privatised banks

On 31 May 2007, the European Commission announced that it has opened a formal investigation into the 2003 Italian provisions which allowed formerly state-owned banks to tax the capital gains arisen from their privatisations in the 1990s with a substitute tax of 9%. The Commission will decide on whether the payment of the substitute tax instead of the corporate tax of 37.25% can be considered a state aid incompatible with article 87 of the EC Treaty.

In the late eighties the Italian banking system was characterised by a significant presence of the State in the bank industry. Starting from 1990 Italy encouraged the privatization of the formerly state-owned banks favouring the contribution of their assets into public limited companies and the subsequent sale of a part of the new companies' shares to private investors by the contributing entities (converted into non-profit bodies so-called "banking foundations").

More precisely, Law no. 218 of 1990 on the privatisation of the Italian banking system provided for the tax neutrality of the contribution of the assets, by establishing that:

- the capital gain which may result from this operation in favour of the banking foundations is not subject to taxation until it is distributed (through the distribution of the capital reserve made up by the capital gain) or realised (through the sale of the shares received); and

- the assets and liabilities contributed to the public limited companies maintain the tax value recognised before the contribution.

In 2000, the private banks were allowed to realign the book and the tax values of their property and of the shares owned by the foundations by paying a substitute tax of 19% on the above-mentioned

difference; alternatively, the private banks could realign only the book and the tax value of their property by paying a substitute tax of 15%.

Article 2(26) of Law no. 350 of 2003 (so-called Financial Law for 2004) extended the application of the 2000 provisions to the year 2003 but it reduced the rate of the substitute tax to be paid at 12% (or 9% in the case of the payment of the substitute tax only to realign the book and the tax value of the property of the private banks). The same Law also established that the payment of the substitute tax could be made in three instalments (50% in 2004, 25% in 2005 and 25% in 2006), without interest payment.

According to the Commission, the 2003 provisions, as they enable the private banks to realign their tax liabilities resulting form hidden capital gains with a tax cost much lower in comparison to the ordinary company taxation, may give the Italian banks an unfair economic advantage by making them more attractive both for investors and corporate acquires. This could have a negative effect on the ongoing consolidation process of the European banks.

The Commission also pointed out that Italy failed to notify the scheme before its implementation and, by means of this investigation, the Commission invited interested parties to comment on the measures under scrutiny. If the Commission decides that the scheme constitutes state aid incompatible with the EC Treaty, Italy would have to recover the aid illegally granted.

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Portugal – European Commission endorses tax reductions for the free zone of Madeira for the period 2007-2013

Under EC Treaty state aid rules, and in the light of the Regional Aid Guidelines for 2007-2013, the European Commission has approved a scheme providing tax reductions worth € 300 million until 2020 to companies setting up in the free zone of Madeira (ZFM) between 2007 and 2013.

According to this scheme, new companies licensed to carry on business in the ZFM between 1 January 2007 and 31 December 2013 will benefit from a reduced tax rate of 3% in 2007-2009, 4% in 2010-2012 and 5% in 2013-2020.

Access to the scheme will be restricted to companies which meet the following specific eligibility criteria:

- Minimum number of permanent jobs created (varying according to the taxable base per company);
- Activities developed restricted to the ones included in a list drawn up by the Portuguese authorities on the basis of statistical classification of economic activities in the EU.

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Portugal – European Commission deems Portuguese tax amnesty contrary to EC Law (Case 2005/4932)

In 2005, the Portuguese Parliament approved a law that allows the disclosure and regularisation of undeclared funds held abroad by filing a confidential statement before 16 December 2005. For this purpose, the relevant law required resident individuals to pay a penalty equal to 5% of the value of the relevant investments; however, a reduced tax rate was established to apply to Portuguese government bonds as well as to any amount of other investments reinvested in Portuguese government bonds at the occasion of the regularisation procedure.

The European Commission considers that measure constitutes a restriction on the free movement of capital, guaranteed by article 56 EC, as it dissuades resident individuals from keeping their regularised assets in other forms than Portuguese government bonds.

Accordingly, the Commission has sent a reasoned opinion to Portugal to eliminate this violation of the EC Treaty, by applying the same fiscal treatment to all regularisations made in 2005.

If Portugal does not reply satisfactorily to the reasoned opinion within two months the Commission may refer this matter to the ECJ.

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European Commission closes infringement proceeding against Spain over Registrar fees

The European Commission had opened an infringement proceeding against Spain over Registrar fees charged upon capital increases of Spanish companies. The Reasoned Opinion, delivered on 10 July 2006, argued that, as such fees are proportional to the increase of capital and bear no relation to the costs of the service rendered, that the way in which registration fees are calculated in Spain is contrary to Article 10(c) of the Capital Duty Directive. According to the Commission, this was confirmed by the ECJ in Case C-264/00 Gründerzentrum, in which the ECJ ruled that duties paid by way of fees or dues, can be lawfully levied only if they constitute remuneration, i.e. an amount which is calculated on the basis of the cost of the service rendered.

After receiving the explanations of the Spanish authorities, the Commission decided to terminate the infringement proceeding against Spain on 5 July 2007. The main reason argued by the Commission is that Registrar fees should not be considered as a tax, to the extent that they are not transferred by the Registrars, in whole or in part, to any public authority. This follows the reasoning of the ECJ in case C-165/03 Längst.

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EU Council of Ministers authorises European Commission to negotiate on Swiss cantonal company taxes

On 14 May 2007, the EU's Council of Ministers adopted a decision to grant the European Commission a mandate to enter into negotiations with Switzerland regarding the application of State aid rules under the 1972 EU-Switzerland Agreement to the corporate tax regimes applied by certain Swiss cantons that exempt foreign-source profits from cantonal and municipal corporate income tax. The mandate follows a request from the Commission to Switzerland, on 13 February 2007, to amend those regimes as they constitute State aid incompatible with the proper functioning of the 1972 EU-Switzerland Agreement (see also EUDTG Newsalert NA 2007 – 005). The aim is to negotiate a mutually acceptable solution for the amendment of those regimes.

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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 27 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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