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ECJ CASES

Belgium – ECJ referral on tax treatment of French-source dividends

On 20 March 2008, the Court of First Instance of Liège submitted a request for a preliminary ruling to the ECJ concerning the Belgian tax treatment of French-source dividends received by Belgian individuals (inbound dividends).

Two questions were submitted to the ECJ:

- Should Article 56 EC be interpreted in the sense that it precludes a restriction, following from the tax treaty between Belgium and France for the establishment of rules of reciprocal administrative and legal assistance with respect to taxes on income, which maintains a partial double tax charge on dividends from shares of companies established in France and which makes the tax charge on those dividends more burdensome than the sole Belgian withholding tax applied to dividends paid by a Belgian company to a Belgian resident shareholder?

- Should Article 56 EC be interpreted in the sense that Belgium is at fault for not having taken any action to renegotiate with France a new way of avoiding the double taxation of dividends from shares of companies established in France?

This new request for a preliminary ruling will have to be analysed in the light of the ECJ's decision in the *Kerckhaert-Morres* case (C-513/04) where the Court dealt with similar but still different issues. Whereas the Belgium-France Treaty was not at issue in the Kerckhaert-Morres case, in the present case at hand it is.

-- Olivier Hermand and Patrice Delacroix, Belgium; olivier.hermand@pwc.be

Belgium – ECJ referral on dividends-received deduction regime

On 16 November 2007, the Tribunal of First Instance of Brugge submitted a request for a preliminary ruling to the ECJ concerning the Belgian dividends received deduction regime (*DRD*) in the case Beleggen, Risicokapitaal, Beheer NV v Belgische Staat (C-499/07).

This referral comes in addition to the previous referrals made by other Belgian courts during the last few months: see a.o.

- the AG's opinion in the *Cobelfret* case (C-138/07) rendered on 8 May 2008 on the question referred to the ECJ by the Antwerp Court of Appeal, and

- the request for a preliminary ruling by the Brussels Court of Appeal lodged on 24 September 2007 on the same type of issue in the *Belgische Staat v KBC Bank NV* case (C-439/07)

The Tribunal of First Instance has referred four questions to the ECJ to clarify whether the DRD regime is compatible with EU rules, in particular the EU Parent/Subsidiary Directive (EU

PSD). These four questions, each of which has already been addressed in other referrals to the ECJ, could have the following consequences if the ECJ ruled in favour of the Belgian taxpayer.

- The 95% deduction on dividends received from EU subsidiaries (resident in Belgium or not – in application of the Leur-Bloem jurisprudence) would not be limited anymore by the level of the taxable profits of the Belgian parent company (which is currently the case), entailing the creation of Belgian tax losses in the cases where the limitation would have applied.

- In addition, the awaited decision might entail that the deduction could not anymore be limited to 95% of the dividends received, but would have to be granted on 100% of the dividends received. The Tribunal refers in this respect to the Belgian tax treatment of profits attributed by a permanent establishment to a Belgian head office (where a 100% exemption method generally applies).

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Belgium – AG opinion on compatibility with EC Law of Belgian rules on the non-deductibility of debts from inheritance tax base if testator was resident abroad: Hans Eckelkamp and Others v Belgian State case (C-11/07)

On 13 March 2008, AG Mazak rendered his opinion in the Hans Eckelkamp and Others v Belgian State case, in which the heirs inherited immovable property situated in Belgium on which a mortgage loan had been taken out.

According to Belgian tax law, transfer duty is due on the value of immovable property in Belgium without deduction of any debts where the deceased is a non-Belgian resident, whereas such debts are deductible where the deceased is a Belgian resident. The heirs filed a tax claim to contest the succession duties they had suffered claiming that the distinction between residents and non-residents is contrary to the EC Treaty provisions on the free movement of capital.

On 18 January 2007 the Court of Appeal of Gent referred a preliminary ruling to the ECJ in order to understand wheteher the Belgian legislation on the taxation of inheritance is compatible with the fundamental freedoms of the EC Treaty.

From the AG's point of view, the Belgian tax authorities cannot refuse, for the computation of the succession duties, the deduction of the debt because the deceased was not a Belgian resident at the time of death if heirs in the same situation but inheriting from a Belgian resident would have had the right to deduct such a debt.

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Germany – ECJ referral on anti-abuse rules under the former German imputation system: Glaxo Wellcome case (C182/98)

Under the former imputation system, distributed profits of resident corporations were taxed at 30%. In order to avoid economic double taxation, shareholders were granted an imputation credit of 3/7 of the distributed dividend. This credit was only granted to *resident* shareholders (certain tax exempt entities excluded). According to most double tax treaties, capital gains are taxable in the shareholder's State of residence, whereas dividends can also be taxed in the State of the distributing company. Instead of receiving dividends without the imputation credit it could accordingly be more attractive for a foreign shareholder to dispose of shares in a German corporation with retained earnings and to be compensated for the underlying imputation credit via a correspondingly tax-free capital gain.

To compensate for the fact that foreign shareholders thus economically received the imputation credit without having taxed the dividend, the "one-time taxation" of the dividend was secured on the level of a resident purchaser of the shares, who realised the imputation credit upon distribution and then wrote down the participation tax effectively. This was technically achieved by the so called *blocked amount* (*Sperrbetrag*). According to this rule, if a resident taxpayer acquired shares from a non-resident shareholder, the difference between the purchase price and the nominal share value (the blocked amount) was assessed at the level of the buyer. If the buyer wrote down the participation due to subsequent dividend distributions, the write-down was non-deductible insofar as it was covered by the blocked amount. This applied irrespective of whether the foreign seller was taxed on the capital gain in his State of residence. It did not apply to shares acquired from a resident shareholder who was not taxable on the capital gain upon disposal of the shares. Upon restructurings such as mergers or conversions into a partnership, the blocked amount caused non-deductibility of merger losses at the level of the surviving partnership. The provision is abolished, however a blocked amount incurred until 2001 leads to the described effects until tax year 2010.

In 1995, the German resident G-GmbH (G) acquired all shares of the German resident W-GmbH (W) from a UK resident shareholder. This caused a blocked amount at the level of G. W was then merged upstream into G and G was converted into a limited partnership. The restructurings released losses that were not deductible due to the blocked amount being tracked through the transactions.

The Federal Tax Court doubted if this provision is compatible with the free movement of capital and the freedom of establishment: The acquisition of shares from non-residents is rendered less attractive as it results in higher taxes for the buyer and equally, foreign shareholders could be discouraged from investing capital in Germany, due to the lower price upon disposal of the shareholdings. The Court stated that the ECJ's decision in the (outbound) *Meilicke* case (NA 2007 - 008) regarding the incompatibility of the German imputation system with EC Law, could affect all provisions deriving from that system, i.e. also the rule in question here which is intended to preserve the consistency of this system. It further referred to the decision by the EFTA Court in the (inbound) *Fokus Bank* case (E-1/04), since the current case concerns an inbound situation. As the Court did not consider the application of EC Law in this respect to be sufficiently clear, especially regarding the

imputation system in inbound situations, it referred the case to the ECJ for a preliminary ruling.

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Germany – ECJ referral concerning double taxation rules: Block case (C-67/08)

On 20 February 2008, the German Federal Finance Court (BFH) referred a new preliminary ruling in the *Block* case to the ECJ.

In 1999, a German resident inherited a bank deposit from her German resident aunt. The bank deposit was at a Spanish bank. The inheritance was taxable both in Spain and in Germany. A Double Tax Treaty concerning inheritance tax does not exist. In general, Germany avoids double taxation by imputing the foreign tax on foreign property. However, an imputation credit is not granted for tax on foreign bank deposits, because this kind of property is not defined as foreign property. From the German point of view, bank deposits in Spain constitute domestic property of which Germany has the whole taxing right. The taxing right of Spain should stand back. Obviously, Spain is of a different opinion and claims an own whole taxing right for the inheritance of Spanish bank deposits. As a result the inheritance was taxed twice.

According to the BFH, the main issues of this case concern the fact that within the EU:

- there is no common understanding concerning the definition of foreign/domestic property and
- the allocation and exercise of taxing rights of Member States (MS) on property without a substantial link to its own territory is not restricted and
- EC-law does not require the MS to amend their tax laws respectively.

As for bank deposits, the BFH stated that the taxing right can be linked to the State of residence of the creditor (testator, Germany) as well as to the State of residence of the debtor (bank, Spain). It is obvious that the inheritance of foreign bank deposits is taxed more heavily than that of a domestic bank deposit. Nevertheless, the BFH asked if and on what reasons Germany has to avoid a double taxation in cases where two States claim their taxing rights.

The referral deals with the following questions:

- Which State has the taxing right or rather which connection to the territory is reasonable?
- Has a double taxation itself to be avoided within the EU?
- Which State has to avoid double taxation: Spain or Germany?
- How is double taxation to be avoided: by exemption method or by credit method?
- How is the exception in Art. 58 para. 1 (a) to be read in connection with Art. 58 para. 3 EC. The provisions in question were applicable long before the end of 1993.

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Germany – ECJ referral on limited deductibility of foreign rental losses and the non-application of declining depreciation for buildings located abroad: Busley/Cibrian case (C-35/08)

Two Spanish nationals (claimants), resident in Germany, inherited Spanish real estate from their parents. The house was rented out from 1 January 2001 until it was sold to the Spanish tenant in March 2006. According to the tax treaty between Spain and Germany, Germany avoids double taxation on income from Spanish real estate by credit of the Spanish tax. When computing the rental income for German tax purposes, the claimants applied for declining depreciation. Declining depreciation is according to German tax law applicable only for buildings located in Germany. For buildings located abroad, the law provides solely for straight line depreciation, which is generally less advantageous. The claimants also applied for unlimited deduction of the Spanish rental losses. German tax law states that losses from such "passive" sources can be set off only against positive income of the same kind from the same country. Where the losses can not be offset in the tax year in which they occurred, they are carried forward and offset against positive income of the same kind from the same country in future years. There was no corresponding limitation of the deduction of German rental losses; such losses could - in principle - be offset against any positive income without limitation in the tax year they were incurred.

The Tax Court of Baden-Württemberg doubted whether these rules comply with the fundamental freedoms, especially with the free movement of capital and accordingly referred the case to the ECJ. According to the Court, the fact that the house was inherited should not make a difference with respect to the applicability of that freedom (see ECJ in van Hilten-van der Heijden, NA 2006 - 005). Furthermore, the Court saw its concerns regarding the denial of unlimited loss deduction confirmed by the judgments in the cases *Ritter-Coulais* (NA 2006 - 003) and *Rewe-Zentralfinanz* (NA 2007 - 013), where the ECJ considered certain paragraphs of the same German tax rule as the one questioned in the present case to be in breach of Community law. Should the ECJ be of the opinion that these rules comply with the free movement of capital, the referring Court asked if they are in breach of Art. 18 EC (the right to move and reside freely within the EU).

Additionally, it should be mentioned that the European Commission has formally requested Germany to end its discriminatory treatment in respect of depreciation of buildings situated abroad (EU Tax News 2008 - 002).

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Netherlands – ECJ referral on extended statutory time limit for issuing an additional tax assessment for foreign income

On 21 March 2008, the Dutch Supreme Court handed down two judgments regarding the extended statutory time limit for issuing an additional tax assessment for foreign income (case 43 670). According to Article 16, paragraphs 1, 3 and 4 of the General Tax Act (*Algemene Wet inzake Rijksbelastingen:* hereinafter GTA), the period for additional tax assessments is five years for domestic income and twelve years for foreign income. The applicants in the proceedings faced additional income and wealth tax assessments under the extended

statutory time limit with respect to savings in Luxembourg and German banks which they had not disclosed in their respective tax returns.

In its judgment the Supreme Court stated that the transfer to and holding of savings in another Member State falls within the scope of the EC Treaty. It held that Article 16, paragraph 4, GTA can have a detrimental effect on the movement of savings, and therefore constitutes an infringement of the free movement of capital and/or services. The question remains whether or not this infringement can be objectively justified.

According to the Dutch legislative history, the extended period with regard to foreign income finds its explanation in the absence of adequate fiscal supervision. According to the Supreme Court, it follows from well established case law that a restriction such as the extended statutory trime limit at hand could be justified in order to guarantee the effectiveness of fiscal supervision (e.g. Case C-101/05, *A)*. The Supreme Court notes in this respect that in case of countries with banking secrecy (such as Luxembourg) recourse to the mutual assistance between competent authorities provided for by Directive 77/799 may not have been very successful. Moreover, the Supreme Court is of the opinion that periodical requests for exchange of information by the Netherlands to other Member States would have been too burdensome for the tax authorities of those Member States. The Supreme Court concludes that there are good arguments in favour of upholding the extended statutory time limit. However, reasonable doubt remains. It therefore requests the ECJ for a preliminary ruling on the following questions:

- Must Articles 49 and 56 EC be interpreted such that these provisions do not preclude that a Member State, in case of (income from) savings which have not been disclosed, for the national tax authorities to apply a legal provision which compensates for the lack of effective fiscal supervision with respect to these foreign savings which extends the period for additional tax assessments to twelve years, whereas the period for domestic (income from) savings, with respect to which effective fiscal supervision is possible, is five years?

- Does it make any difference whether the other Member State has a banking secrecy law?

- Do Articles 49 and 56 EC preclude that tax penalties for not reporting foreign savings are calculated in proportion to the tax additionaly assessed under the extended time limit?

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Poland – ECJ referral concerning non deduction of health premiums

A German national, resident in Poland ("Individual"), derives from German sources: (i) a kind of public social pension and (ii) pension from its work place. These pensions are paid to the bank account of the Individual located in Germany, where health premiums for public health security purposes are withheld.

Based on the tax treaty between Poland and Germany, public social pensions are taxed in the country where they are paid (i.e. in Germany), while pensions from work places are taxed in the country of taxpayer's residence (i.e. in Poland).

The Individual approached the Polish tax authorities for a tax ruling confirming the possibility of deducting health premiums (paid in Germany) from Polish Personal Income Tax ("PIT") due on pensions received in Germany from his work place.According to the Polish tax authorities, the Individual is not entitled to deduct health premiums paid in Germany from Polish PIT, since these premiums are paid under the German laws, while the Polish PIT Law allows deducting health premiums paid based on the Polish Act on health services only. The Individual appealed against the tax authorities' decision to the Provincial Administration Court of Wroclaw.

While analysing the PIT Law, the Court doubted whether the provisions on deducting health premiums from PIT are in line with non-discrimination and free movement of workers rules resulting from Art. 12 and 39 EC.

The Court pointed out that the character of health premiums paid in Germany is similar to those covered by the provisions of the PIT Law at question and that the Individual, although a citizen of Germany, should be treated as a tax resident of Poland (like most of individuals paying health premiums in Poland), since he permanently lives in Poland.

Furthermore, the Court noticed that, based on the EC regulations, all health services rendered in Poland by Polish health institutions to the Individual are reimbursed by the German health institution. Hence, the Individual pays for health services received in Poland indirectly, while individuals, who pay health premiums in Poland per directly. The Court also stated that contrary to health premiums paid in Poland, health premiums paid by the Individual in Germany do not participate in the overall costs of functioning of the Polish public health system.

Given the above, the Court took doubts whether the facts that (i) the Individual pays only for health services actually received (and does not participate in the overall costs of functioning of the Polish health system) as well as that (ii) these payments have an indirect character are essential / enough to justify different tax treatment of the Individual in comparison to the individuals paying health premiums in Poland.

Moreover, the Court stressed that apart from the EC Treaty's provisions, there are specific EC Regulations stipulating the principle of similar treatment of insured citizens and prohibition from discrimination because of nationality.

As a consequence, the Court asked the ECJ whether the Polish PIT Law provisions covering the possibility of deducting health premiums but only those paid in Poland from PIT are in breach of the EC Treaty.
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Portugal – ECJ referral on discriminatory taxation against foreign banks

In December 2005, the European Commission issued a Reasoned Opinion to Portugal in order to ask for an amendment to Portuguese tax law regarding the taxation of outbound interest payments, which was considered discriminatory on the following grounds.

According to Art. 80 (2) (c) of the Portuguese Corporate Income Tax (CIT) Code, a withholding tax of 20% shall apply to the *gross* amount of interest paid by Portuguese resident borrowers to non-resident lenders, as non-resident banks are not allowed to deduct respective funding costs. On the contrary, interest paid to resident financial institutions shall not be subject to withholding tax, but only to CIT, meaning that net interest received will be subject to Portuguese corporate income tax. Thus, in most cases, foreign banks pay a higher tax in Portugal than Portuguese institutions.

On 6 March 2008, the Commission referred Portugal to the ECJ requesting it to declare that by taxing payment of interest abroad more heavily than payment of interest to entities resident in Portuguese territory, the Portuguese Republic imposes restrictions on the provision of mortgage and other loan services by financial institutions resident in other Member States and in States party to the EEA Agreement, and it has therefore failed to fulfil its obligations under Articles 49 and 56 EC Treaty and Articles 36 and 40 of the EEA Agreement.

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Spain – ECJ referral on (former) capital gains tax rules (Case C-562/07)

On 14 July 2005, the European Commission sent Spain a formal request to amend several tax provisions, including the rules on taxation of capital gains derived by non-residents, on the understanding that they were in breach of the freedom of movement for workers and the free movement of capital (Articles 39 and 56 EC).

Under the rules then in force, capital gains derived by Spanish residents were taxed under a progressive rate schedule if the period of tenure was less than one year, or at a 15% flat rate if the period of tenure exceeded one year. Capital gains derived by non-Spanish residents were taxed at a 35% flat rate, irrespective of the period of tenure.

Spanish tax legislation was amended by Law 35/2006 effective as of 1 January 2007. Under the current legislation, capital gains derived by both residents and non-residents are generally taxed at an 18% flat rate, irrespective of the period of tenure.

As the said amendment did not affect the legislation in force up to 31 December 2006, the Commission referred Spain to the ECJ on 19 December 2007, on the grounds that there is no objective difference between resident and non-resident taxpayers, so that the higher tax burden on non-residents is discrimination which unlawfully restricts freedom of movement for workers and the free movement of capital, as provided for in Articles 39 and 56 EC and Articles 28 and 40 of the EEA agreement.

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Spain – ECJ judgment on R&DT innovation tax credit scheme (Case C-248/06)

On 13 March 2008, the ECJ ruled that Spain has failed to fulfil its EC Treaty and EEA Agreement obligations with regard to the freedom of establishment and freedom to provide services by maintaining in force rules for R&D and Technological Innovation tax credits which are more onerous for R&D activities carried out outside of Spain.

The Spanish Corporate Income Tax Law (Art. 35) establishes an R&D and Technological Innovation tax credit. R&D and Technological Innovation expenses incurred abroad may qualify for this tax credit provided that the main R&D and Technological Innovation activity is carried out in Spain and the expenses incurred abroad do not exceed 25% of the total. Subcontracted activities can also qualify for this tax credit, benefiting from a more beneficial treatment when they are subcontracted with universities, public research organizations or innovation and technology centres registered according to the Spanish regulations.

As Spain did not reply to the Reasoned Opinion sent by the European Commission on 5 July 2005, the case was referred to the ECJ.

The Commission considered that the Spanish legislation at hand resulted in an unjustified restriction of the freedom of establishment and the freedom to provide services, as per the following reasoning:

- R&D and Technological Innovation activities performed by taxpayers result in a more limited tax credit when carried out outside of Spain.
- The Spanish legislation only allows the tax credit for subcontracted activities where subcontracted in Spain.
- The official recognition of the subcontracted centres is limited to institutions located in Spain. The Commission submits that this is contrary to the freedom of establishment.

The Spanish Government argued that the Spanish tax measure did not result in a restriction of the aforementioned freedoms but, even if that was the case, such restriction would be justified by the need to promote R&D and Technological Innovation activities in Spain and to tackle tax evasion by preventing companies from taking a double deduction: in Spain and abroad.

However, following the *Baxter and Others* (C-254/97) and *Laboratoires Fournier* (C-39/04) decisions, the ECJ ruled that the Spanish measures at hand do constitute a restricition of the freedom of establishment and the freedom to provide services, established in Art. 43 and 49 EC Treaty and Art. 31 and 36 EEA Agreement, respectively, and that these restrictive measures are neither suitable to promote R&D and Technological Innovation activities in Spain nor to combat tax fraud, or, at least, go beyond what is necessary to attain those objectives.

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United Kingdom – ECJ Order on CFC and dividend group litigation issues (C 201/05)

The ECJ has issued its judgment on the controlled foreign companies (CFC) and dividend group litigation by written order.

The order supports the previous decisions in *Cadbury Schweppes* (C-196/04) and the *Franked Investment Income Group Litigation* (C-446/04). In summary, in line with the earlier decisions, the ECJ decided that:

- the dividend legislation represents a breach for shareholdings of less than 10%, as no credit is given for underlying tax;
- the dividend legislation only represents a breach for shareholdings of 10% or more if overseas dividends are taxed less favourably than UK dividends (for the UK courts to determine); and
- the CFC legislation only represents a breach to the extent that it requires information regarding tax arrangements which are not wholly artificial (for the UK courts to determine).

The CFC and Dividend Group Litigation is a group of taxpayers challenging whether the UK CFC provisions (which tax certain profits of non-UK companies where these are considered to have been subject to a lower level of tax) and dividend provisions (which tax dividends received from non-UK companies but not those received from UK companies) are compliant with fundamental EU principles.

As the questions to be addressed in the group litigation were identical to those already addressed in earlier cases, or could easily be deduced from existing case law, the ECJ delivered its decision by written order.

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NATIONAL DEVELOPMENTS

Finland – Supreme Administrative Court decision on withholding liability on Finnish source dividend paid to non-resident individual

The Finnish Supreme Administrative Court ("SAC") issued a decision on 8 April 2008 on withholding liability of a Finnish resident company on dividends paid to its UK resident individual shareholder (SAC:2008:23). The SAC decision was given to an appeal made by the tax authority on previous Central Tax Board ruling 10/2007 (for the CTB ruling, please see EUDTG Newsletter 2007 – nr. 3).

A Finnish national shareholder of a non-quoted Finnish family owned company has been living permanently in the UK since 2002. She was considered as tax resident (unlimited tax

liability) in Finland during 2002-2005. As from 2006 onwards, the shareholder was considered as non-resident (limited tax liability) for Finnish tax purposes. According to the Finnish Income Tax Act, dividends received by a Finnish resident individual taxpayer from non-quoted companies are tax exempt up to the 9% of annual profit of the mathematical value of the share if the amount of the dividend does not exceed 90.000 EUR. The dividend exceeding the amount of 90.000 EUR (but max. 9% of the mathematical value) is partly taxed as capital income at a rate of 28% (70% taxable, 30% tax exempt). Dividends exceeding "the 9% mathematical value limit" are partly taxed as earned income at progressive tax rate (70% taxable, 30% tax exempt). However, dividends received by non-resident taxpayers are taxed according to the Withholding Tax Act at the rate of 28% of the gross amount of the dividend.

In the case at hand, the non-resident shareholder receives no other non-quoted company dividend income than the dividend from the Finnish family company. The applicant therefore claimed the UK resident shareholder to be in a similar situation with a resident taxpayer receiving dividends from the same company. Because the tax on the dividend would likely be higher for a non-resident than tax for a resident dividend recipient, the applicant asked whether the EC Treaty freedoms (Art. 18, 43 and 56 EC) should be invoked, and requested the Board to consider the dividend taxable according to rules applicable mainly to residents.

The Finland-UK Tax Treaty Art. 6 shifts taxing rights to Finland in cases where assets are not transferred to the UK and are not taxed there. Since the dividend is paid to a Finnish bank account, the dividend is taxed entirely according to Finnish domestic legislation, based on the Withholding Tax Act and at a tax rate of 28% on the gross amount of the dividend.

In the case at hand, SAC recognized the objectively comparable situation of the non-resident and resident shareholders, and stated that the non-resident cannot be taxed in a more burdensome way. SAC stated that the most EC Tax Law compliant way to solve the issue would be to withhold the exact same amount of tax at source as would be the tax liability of a resident individual shareholder. However, as the dividend carries an element (earned income) which is ultimately taxed at a progressive tax rate which is determined pursuant to the total amount of earned income per calendar year, it is virtually impossible to withhold the correct amount of tax at source at the time of dividend distribution (which is typically made in the first half of calendar year).

Therefore SAC did not change the previous CTB decision, i.e. it concluded that in the case at hand, the Finnish resident company was liable to withhold tax according to the non-resident shareholder rules.
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Finland – Supreme Administrative Court confirms earlier ECJ decision on the consistency of Finnish transfer tax with the Capital Duty Directive (C-240/06, Fortum Project Finance)

The Finnish Supreme Administrative Court (SAC) handed down its judgement on 29 February 2008 with respect to the Finnish transfer tax levied in share-for-share transactions, better known as the ECJ's case C-240/06, *Fortum Project Finance*. The judgement covered the

ECJ’s decision handed down on 25 October 2007 on the possible infringement of the transfer tax of Art. 56 EC and Art. 12(1)(c) of the Directive 69/335/EEC concerning indirect taxes on the raising of capital (hereinafter “Capital Duty Directive”). Taking into account the ECJ’s decision, the Finnish SAC rejected the appeal of Fortum Project Finance SA and stated that Finland is entitled to levy such a transfer tax.

The case concerned transfer tax liability based on a contribution in kind (the shares in Fortum Heat and Gas Oy) by a Finnish resident parent company Fortum Oyj to a Luxembourg resident Fortum Project Finance SA´s share capital. Fortum Oyj would receive newly issued shares in Fortum Project Finance SA as a consideration. According to Finnish domestic tax legislation transfer of ownership in Finnish shares triggers Finnish transfer tax liability for Fortum Project Finance SA.

In its decision, the ECJ stated that it is not necessary to examine the matter in relation to Art. 56 EC since the Finnish provisions are applied both to domestic and cross-border transfers of shares, and therefore are not directly or indirectly discriminatory. The ECJ considered the Finnish transfer tax not to be in breach with the Capital Duty Directive, since this kind of tax is allowed on the basis of Art. 12 para 1 subpara a. Accordingly, the ECJ was of the opinion that Art. 12 para 1 subpara c prohibits only levying of taxes on investments of other property items than securities, real estate, and business asset entities (mentioned in subparagraphs a and b) into a capital company, when consideration is shares in the receiving company.

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Germany – Case pending with the Federal Tax Court regarding exit tax on goodwill

A German resident individual (claimant) carried out business as a sales agent in Germany. In 1993, he relocated the business to Luxembourg. Due to the migration, the tax authorities increased his taxable income with a goodwill amounting to DM 700,000.

According to German case law, relocation of a business to another country resulting in the withdrawal of assets from the German tax jurisdiction, i.e. that Germany can no longer tax unrealised reserves in the business, equals a closing down of the business and the "gain" is accordingly taxed.

In the present case, the tax authorities argued that the relocation to Luxembourg led to a disclosure of the inherent goodwill: The claimant had an agent district and protected area of representation from which sustainable profits could be derived. The goodwill would in the future solely be utilised and exploited in Luxembourg and could therefore be taxed upon migration.

The Tax Court of Rheinland-Pfalz, to which the claimant appealed, considered the immediate taxation of the goodwill upon migration of the business as an infringement of the freedom of establishment, referring to the ECJ judgment in *Lasteyrie du Saillant* (C-9/02). It further referred to the ECJ judgment in "*N*" C-470/04 (NA 2006 - 021) and stated that taxation by a Member State of a value increase that has occurred during the residency of a taxpayer in that State is not generally in breach of EC Law, however, that it is decisive how the national rule is

designed. Even considering the still considerably vague jurisprudence by the ECJ, the court was of the opinion that immediate taxation infringes the freedom of establishment. Upon a true closing of a business, goodwill ceases to exist and is thus not taxed. Given the freedom of establishment, there is no adequate reason to tax inherent goodwill upon migration to another Member State in advance, also considering that the amount of the goodwill is yet uncertain. Further, taxation as a last resort or ultima-ratio is not to be accepted: Due to the taxation on an inherent value increase in the goodwill so far has not been waived by the revenue, i.e. the goodwill had not been depreciated, the revenue cannot be considered as simply reversing this waiver by taxing the goodwill upon migration. The not yet realised goodwill of DM 700,000 could accordingly not form part of the taxable profit.

The claimant had further transferred other assets to Luxembourg and as it could not be shown that these formed part of a Luxembourg PE of the claimant, the Court considered the immediate taxation here not to be in breach of EC Law.

Due to the importance of the legal questions, the case was admitted to the Federal Tax Court, where it is now pending.

-- Caroline Wunderlich and Juergen Luedicke, Germany; juergen.luedicke@de.pwc.com

Germany – Case pending with the Federal Tax Court regarding withholding tax on outbound dividends

A Swiss corporation (claimant) held a portfolio shareholding in a Germany company in year 2002. On the dividends distributed, German withholding tax and solidarity surcharge of 21.1% were withheld. A partial refund down to 15 % withholding tax was granted to the claimant in accordance with the German/Swiss tax treaty.

Withholding tax of 21.1 % is also levied upon distributions to German resident corporate shareholders. In computing the income for such shareholders however, dividends are deducted from the taxable basis and the withholding tax is credited or - if the final tax burden is lower - refunded by way of assessment. As a result, the dividends are not taxed (apart from tax on 5 % non-deductible expense). This does not apply to non-resident shareholders that are not assessed in Germany. For them, the withholding tax is final.

The claimant applied to have the remaining 15 % withholding tax refunded with the Central German tax authority competent for double tax treaty reductions and certain other international tax matters. The authority issued a negative decision, thereby also stating that the *local* tax authority is competent for applications of refund exceeding double tax treaty reductions. The claimant accordingly applied for a refund of the remaining withholding tax with the local tax authority competent for the distributing German company.

In court proceedings with the Tax Court of Baden-Württemberg, the claimant argued that the final withholding tax infringes Community law. The Court did not see a breach of the free movement of capital and furthermore stated that if the final withholding tax were to be considered as infringing Community Law, the Central German Tax Authority would be the competent authority for a refund application!

Due to the importance of the legal questions, the case was admitted to the Federal Tax Court, where it is now pending.

Since the case concerns the fundamental question in respect of the free movement of capital to non-EU Member States, it is to be hoped for that the German Federal Tax Court does not choose to dismiss the case based on the fact that the refund was applied for with the "wrong" authority, but instead refers the case to the ECJ. It should be noted that German law does not foresee a procedure for non-resident taxpayers to apply for a refund based on EC Law. To then claim that the taxpayer has chosen the "wrong" procedure does in our view infringe the basic EC Law principle of effectiveness.

Further, the Commission has started an infringement procedure against Germany due to the discriminatory treatment of dividends paid to non-resident corporate shareholders within the EU/EEA (see EU Tax News 2007 - nr. 005).

-- Caroline Wunderlich and Juergen Luedicke, Germany; juergen.luedicke@de.pwc.com

Germany – Case pending with the Federal Tax Court regarding capital gains taxation upon migration

According to German law as applicable in 1998, individuals that had held more than 25% of the shares in a German corporation during the previous five years were taxed on the capital gain upon sale of such shares. Irrespective of an actual sale of the shares, the tax was also due if a German citizen that had been resident in Germany for 10 years ceased to be a German resident, Sec. 6 International Transactions Tax Act, i.e. an exit tax was due.

Due to an infringement procedure by the European Commission following the ECJ decision in Lasteyrie du Saillant (C-9/02), the German Finance Ministry issued a Decree in 2005, stating that if an individual migrates to another EU/EEA Member State, the exit tax is deferred on an interest-free basis and without security. The deferral is revoked if the individual ceases to be resident in an EU/EEA Member State. It can also be revoked if certain information obligations are not met by the taxpayer. This rule which was enacted in Sec. 6 International Transactions Tax Act only in 2006, is however retroactively applicable to all open tax assessments.

In the present case, a German citizen was resident in Germany for more than 10 years before moving to Belgium in 1998. In 2001, she moved to Switzerland (present domicile unknown). The tax authorities estimated her participation in German companies to be more than 25 % during the 5 years before migration. The tax authorities applied Sec. 6 International Transactions Tax Act and assessed an exit tax. The taxpayer appealed, stating that the application of the rule is incompatible with EC Law: The new rule which should remedy the incompatibility of the previous rule was enacted only in 2006. The retroactive application for previous years is therefore illegal. She referred to ECJ case law stating that the incompatibility of national tax legislation cannot be healed by a Decree, but only by a provision with the same legal status as the unlawful provision. The claimant stated that at the time of migration, she was allowed to rely on the fact that the German tax provisions were in breach of EC Law and accordingly, she should not pay any exit tax.

The Tax Court of Duesseldorf did not consider the application of Sec. 6 International Transactions Tax Act as an infringement of EC law. It referred to the ECJ judgment in the "N" case (NA 2006 - 021) where it was decided that exit taxation restricts the freedom of establishment, but may be justified by reasons of general interest if the proportionality principle is complied with. According to the Court, the German provision is not disproportionate, since the tax is deferred free of interest and without security. The information obligations are also not disproportionate and reductions in share value are considered if the tax deferral is revoked. The Court doubted if the taxpayer's relying on the incompatibility of national law with EC Law is worthy of protection: At the time of migration to Belgium, Sec. 6 International Transactions Tax Act was applicable and at that time, there were no concerns regarding its compatibility with EC Law. In addition, the national law was changed to the taxpayer's benefit, so that the retroactive application is admissible.

Due to the importance of the legal questions, the case was admitted to the Federal Tax Court, where it is now pending.

--Claudia Mencke and Caroline Wunderlich, Germany; caroline.wunderlich@de.pwc.com

Germany – Case pending with the Federal Tax Court on imputed interest on an interest free loan

In the case at hand, a German resident individual held 75% of the shares in a UK Ltd. The shareholder granted an interest free loan to the UK Ltd. Based on Sec. 1 International Transactions Tax Act, the tax authorities increased the taxable income of the German shareholder with imputed interest on that loan. The taxpayer appealed against this treatment.

Sec. 1 International Transactions Tax Act applies to business transactions with foreign related parties only, i.e. a corresponding interest revenue adjustment is not carried out where a German resident shareholder grants a loan to a German resident corporation, in which he holds a qualifying participation. The Tax Court of Duesseldorf opined that the application of this provision might violate the freedom of establishment and the free movement of capital, as it restricts resident persons in carrying out economic activity abroad. It doubted that this restriction can be justified by the tax authorities' argument that Sec. 1 International Transactions Tax Act implements the arm's length principle in Art. 9 OECD Model Convention into German tax law and that this principle of profit and income determination is recognised internationally. Furthermore the Court raised the question of whether or not Sec. 1 of the International Transactions Tax Act can be justified by reasons of general interest and whether it complies with the principle of proportionality.

Due to the importance of the legal questions, the case was admitted to the Federal Tax Court, where it is now pending. It is doubtful, however, if the Federal Tax Court will refer the question to the ECJ as it might - due to the wording of the national provision in the year of the case at hand - qualify the addition of fictitious interest as not being covered by the wording of Sec. 1 International Transactions Tax Act.

--Claudia Mencke and Caroline Wunderlich, Germany; caroline.wunderlich@de.pwc.com

Germany – Lower court judgment on rules on the adding back of interest payments to the tax base

On 22 February 2008, a lower Finance Court (FG) gave its decision on the compatibility of the adding back of interest payments to the tax base (trade tax) with the Interest-Royalty Directive (IRD) and the freedom of establishment.

In 2003, a Dutch B.V. (parent) made a long term loan at an interest rate of 5% to a German resident GmbH (G). According to a German trade tax provision, one half of the interest for a long term loan was to be added back when determining the tax base. Thus, interest payments made by G were only deductible up to 50%. If the interest was paid within a domestic fiscal unity (*Organschaft*) the adding back would be waived. G appealed against the tax assessment, arguing that the provision was in breach of the IRD and the freedom of establishment.

Although the FG rejected the appeal on other (doubtful) reasons, the Court nevertheless submitted interesting arguments regarding a possible infringement of the IRD that could also be valid for the current add back of interest rules (trade tax) and thin-capitalization rules (corporate/income tax).

Arguments contra infringement/application of IRD:

- According to the Considerations No. 1 IRD the Directive wants to equalize the taxation of transactions between companies of different Member States and between purely domestic transactions. As the provision at stake is equally applicable to domestic and cross-border transactions it does not lead to discrimination.

- According to the Considerations No. 2 IRD the Directive aims at avoiding double taxation. When interpreted in the meaning of avoiding the juridical double taxation of the creditor, the provision does not infringe the IRD, because it taxes the debtor and not the creditor.

Arguments pro infringement/application of IRD:

- Although the provision determines the tax base of the debtor, it could be considered as an income tax of the creditor. The FG therefore referred to the *Athinaiki* ruling, C-294/99, whereupon a provision has to be considered having regard to its objective characteristics irrespective of its national classification.

- The German translation of the IRD, using the term *Einkünfte* (income) instead of *payment*, could be doubted. The term *payment*, however, may indicate that the IRD aims not only at the taxation of the creditor but also at the taxation of the debtor. Thus, the scope of the IRD could be to avoid economic double taxation of the payment itself. Otherwise it would be possible to circumvent the IRD by taxing the debtor instead of taxing the creditor. Again, the FG referred to the *Athinaiki* decision.

- Art. 4 para. 1 a IRD excludes the distribution of profits form the benefits of the IRD. Because a reclassification of interest into distribution has the same effect as the non-deductibility of expenses (interest), the FG is willing to take this as a hint that the taxation (of non-deductible interest) of the debtor also falls within the scope of the IRD.

Concerning the freedom of establishment, the plaintiff objected to the unfavourable treatment of cross-border groups. As an *Organschaft* cannot be set up with foreign entities, the add back of interest will not be waived. The Court, however, denied an infringement and quoted the ECJ decisions in the cases *Marks & Spencer*, C-446/03, and *Oy AA*, C-231/05. After these decisions, the non-deductibility of (non-final) cross-border losses as well as cross-border group contributions are permissible. The FG was of the opinion that EC Law does not require a cross-border attribution of income. As the waiving of adding back of interest within the *Organschaft* was just an unavoidable consequence of an intra group income attribution, its waiving was not required in cross-border situations.

The plaintiff applied for an appeal on questions of law; the case is still pending.

-- Gitta Jorewitz and Juergen Luedicke, Germany; juergen.luedicke@de.pwc.com

Italy – Tax Authorities' Resolution on the application of Tax Treaties for pension funds and investment funds

The Italian Tax Authorities recently issued Resolution no. 167/E, which clarified the requirements that pension funds and investment funds, which are not resident in Italy, must meet in order to apply the rules provided for by the Tax Treaties executed between their State of residence and Italy. The case analysed by the Italian Tax Administration concerned certain distributions of dividends from Italian companies to a Dutch pension fund (a non-profit entity set-up as a *stichting pensioenfond*) via a Luxembourg investment fund (*fonds commun de placement*, FCP).

The general principles expressed by the Italian Tax Authorities are described below.

- Foreign investment funds, which are transparent for tax purposes pursuant to their domestic law, cannot apply the provisions of the Tax Treaty executed between their State of residence and Italy. In fact, such entities are not liable to comprehensive taxation in their State of residence, and, therefore, cannot be considered "resident" within the meaning provided for by the OECD.

- Foreign pension funds can apply the Treaty rules, if they are considered "persons" and are "resident" for tax purposes in their State of residence.

- Such entities can be qualified as "persons", in line with the principles expressed by the OECD, if they are treated as legal entities for tax purposes pursuant to the domestic law of their State of residence and no specific provisions regarding pension funds are included in the relevant Treaty.

- Moreover, such entities are "resident" for tax purposes in their State of residence, if they are "liable to tax" pursuant to the domestic law of that State, even though they benefit from a general tax exemption (and, therefore, they are not "subject to tax"). This principle is laid down in paragraph 8.2 of the Commentary to article 4 of the OECD Model, which states that "a person is considered liable to comprehensive taxation even if the Contracting State does not in fact impose tax" as in the case, for example, of pension funds, charities and other organisations that may be exempted from tax.

- Pension funds, which meet the above-mentioned requirements and, therefore, can apply the Tax Treaty rules, are considered the "beneficial owners" of the Italian source dividends, i.e. the persons to whom the dividends are attributable for tax purposes, even though no actual tax is levied because of the general exemption regime applicable to those persons.

It is the first time that the Italian Tax Authorities expressly made a clear distinction between the concept "liable to tax" and the concept "subject to tax", by relying entirely on the principles laid down in the Commentary to the OECD Model. It is also noteworthy that the Italian Tax Administration expressly stated that, in order to determine if a Tax treaty is applicable from a certain entity, reference should always be made to the domestic law of the State of residence of that entity.

-- Claudio Valz, Italy; claudio.valz@it.pwc.com

Netherlands – Supreme Court judgment on recognition of foreign charitable institutions

On 21 March 2008, the Supreme Court gave its judgment on the question whether Article 24, paragraph 4, of the Dutch Inheritance Act 1956 (hereinafter: DIA) constitutes a restriction on the free movement of capital.

In 2002 the applicant, a charitable institution established in the United Kingdom, inherited a part of the estate of a deceased person who was living in the Netherlands. Since this institution was not resident in the Netherlands, the special Dutch inheritance tax rate of 11% for charitable institutions (*algemeen nut beogende instellingen*) could not be applied. Instead, the inheritance was taxed at a rate of 50%.

In its decision of 1 March 2006, the Court of Appeal of the Hague concluded that the aforementioned provision in the DIA is compatible with the EC Treaty, based on the fact that the special rate of 11% could have been obtained if the State of residence (UK) would have submitted a statement of reciprocity (*wederkerigheidsverklaring*) as mentioned in Article 67, paragraph 2 letter d, DIA.

In its judgment, the Supreme Court did not follow this reasoning by the District Court. It held that the differential treatment of resident and non-resident charitable institutions constitutes an infringement of Article 56 EC. Regarding a possible legitimate justification, the Dutch Minister of Finance stated that the effectiveness of the Dutch fiscal supervision is undermined if the

recipient of the amount, received pursuant to the Dutch inheritance law, is established outside the Netherlands. The Supreme Court rejected this possible justification, since the Dutch government can easily request evidence as to whether the non-resident charitable institution meets the requirements to be qualified as such under Dutch tax law (Case C-386/04, *Centro di Musicologia Walter Stauffer*).

As of 1 January 2008, EU charitable institutions can register themselves in the Netherlands as such if they meet the requirements under Dutch law. As a result they should be treated equally to domestic charitable institutions (at present charitable institutions are exempt from inhertitance tax and they can receive tax deductible gifts).

-- Sjoerd Douma and Jaap Pronk, The Netherlands, sjoerd.douma@nl.pwc.com

Netherlands – Lower court circumvention of the question on whether the exit tax is compatible with freedom of establishment

In a recently published decision of 17 December 2007, the District Court of Haarlem was asked to give its judgment on the EC compatibility of an exit tax levied upon the transfer of the place of effective management of X B.V. (the taxpayer) from the Netherlands to the United Kingdom.

X B.V. forms a fiscal unity with its 100% shareholder Y Holding B.V. X BV has a substantial GBP debt claim on a UK group company.

In order to avoid taxation on currency gains resulting from this debt claim, the following set of transactions was undertaken. First, X B.V. transferred its effective management to the United Kingdom. Second, the financial year of the fiscal unity was altered as a result of which the migration was allocated to the (short) former financial year. Third, the fiscal unity was ended by transferring the shares of BV X to a UK group company in the next financial year.

Under the then applicable regime, a fiscal unity ended with retroactive effect as from the beginning of the financial year. Under that regime, the Dutch Supreme Court ruled that an exit tax could not be imposed in the period that the migrating company formed part of a fiscal unity.

Since the taxpayer expected an amendment of the law to repair this decision, the set of transactions – in particular the alteration of the financial year – was needed to benefit from the situation that taxation of the currency gain on the debt claim could be circumvented.

The Court held that tax avoidance was the decisive motive for the alteration of the financial year and applied the abuse of law doctrine by ignoring that alteration.

The applicant then stated that the levy of an exit tax infringes the Articles 43 and 56 EC. The Court however concluded that, should the exit tax be considered a restriction on the freedom of establishment, the restriction is justified since the alteration of the financial year is wholly artificial and as such aimed at tax avoidance.

-- Irma van Scheijndel, Frauke Davits and Jaap Pronk; Netherlands,

Norway – New interpretative statements from the Directorates of Taxes regarding investment funds resident within the EEA and the tax exemption method

The Norwegian Directorates of Taxes have issued three interpretative statements concerning whether investment funds resident within the EEA were covered by the tax exemption method (TEM). The Directorate maintained that none of the funds were comparable to Norwegian investment funds since none of the funds were subject to corporate taxation. The fact that one of the investment funds was subject to 15 % tax on dividends and one of the other paid a tax upon distribution from the fund was not decisive. As Norwegian investment funds seldom pay taxes due to the TEM and because the management fee is deductible for tax purposes, it is difficult to see how the statements could not be seen as discriminatory towards EEA based investments funds and thus contrary to the EEA Agreement.

-- Aleksander Grydeland, New York, and Daniel M. H. Herde, Oslo

Poland – Lower court judgment on taxation of interest earned by EU-based investment funds

On 14 March 2007, the Polish Voivoidship Administrative Court ruled (oral ruling) that interest earned by a Luxembourg SICAV on a bank account held with a Polish bank should be exempt from withholding tax in Poland.

The Luxembourg SICAV received interest income from Polish sources. The bank paying the interest withheld 10% withholding tax from payments made to the SICAV. The withholding tax rate resulted from the double tax treaty between Poland and Luxembourg.

Polish investment funds (both open–end and closed-end investment funds) benefit from subjective exemption from corporate income tax ("CIT") in Poland according to Art. 6 sec. 1 point 10 of the Act on Corporate Income Tax Law. The only condition of the exemption is that the fund has to act pursuant to the provisions of the Act on Investment Funds. No other special requirements need to be fulfilled by the funds. The exemption concerns all income (including interest) derived by the Polish fund i.e. from Polish and non-Polish sources.

The Luxembourg SICAV applied for a refund of the 10% withholding tax to the local tax authorities. The refund claim finally landed at the level of the Polish Voivoidship Administrative Court. The Luxembourg SICAV used two lines of arguments in the refund claim:

1) arguments based on the Polish CIT Law: the SICAV is entitled to benefit from withholding tax exemption in Poland as a fund acting pursuant to the provisions of the Act on Investment Funds.

2) arguments based on Article 56 of the EC Treaty, which guarantees the freedom of capital flow and forbids discrimination of foreign entities in comparison to the domestic ones (i.e. Polish investment funds).

Generally, the court accepted the two lines of argument and confirmed that the Polish laws should be interpreted in line with the EU law and ECJ rulings (EU law prevails). The court acknowledged that interest paid to the Luxembourg SICAV is not subject to withholding tax in Poland and that the refund request is justified. We are expecting to receive a written verdict within the next two months that should reveal the court's way of argumentation in its entirety.

-- Jakub Zak and Agata Oktawiec.

Sweden – Supreme Court judgment on exit charge

The case is about a Swedish company moving its place of effective management and control from Sweden to Malta and becoming tax resident there (under the tie breaker rule in the tax treaty between Sweden and Malta). Because all income came from real estate in the UK, the company would thus not be liable to tax in Sweden anymore on its income. Under Swedish domestic rules, this would trigger an exit charge.

On September 26, 2006, the Swedish Advance Tax Ruling Board stated that it would contravene the freedom of establishment within the EU to impose the exit charge immediately, i.e. when the company moved its place of effective management to Malta. Immediate taxation would be a disproportionate measure, the board concluded. The more proportionate measure would be to charge the tax once the real estate was actually disposed of by the company, even if the company then was not tax resident in Sweden

The board, more as an *obiter dictum*, went on to say that there already were rules in force in Sweden allowing Sweden to charge the tax upon the future disposal event. The secretary of the board disagreed.

The ruling was appealed to the Supreme Administrative Court which handed down its judgment on April 24, 2008. The Court agreed with the board that an immediate taxation, i.e. at the shift of the residence, would be unproportionate and could not be allowed. In contrast to the board, however, the court did not rule on whether the Swedish rules actually will allow a future tax charge. This question is therefore without answer. One of the judges, however, expressed the opinion that domestic rules in combination with the tax treaty actually do not allow Sweden to levy tax on income, except for reversal of some deferrals, or gains. The other judges did not disagree, they just concluded that this was a question that was never raised by the company.

We find it difficult to find support in the Swedish tax rules for the “delayed” taxation model. Every taxation measure must be based on legislation (the principle of legality, “*nullum tributum sine lege*”).

-- Fredrik Ohlsson and Sven Erik Holmdahl; Sweden; gunnar.andersson@se.pwc.com

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EU DEVELOPMENTS

Estonia amends discriminatory legislation regarding the taxation of dividends paid to foreign pension funds

The European Commission has announced that Estonia has amended its legislation in line with EC Treaty rules regarding the taxation of dividends paid to foreign pension funds on 26 March 2008.

-- Bob van der Made, The Netherlands; bob.van.der.made@nl.pwc.com

European Commission requests Hungary to end discriminative tax incentives for R&D

The European Commission has requested Hungary to change its tax law provisions, which limit the granting of a tax incentive to taxpayers who engage in R&D activities performed on premises located in Hungary. This request was addressed to Hungary at the beginning of April 2008, and reasons that under the Hungarian regulations, basic research, applied research or experimental development services performed on premises managed by a research institution founded by a Hungarian institution of higher education or the Hungarian Academy of Sciences are treated more favourably than similar R&D activities performed on similar premises located in other EU Member States or EEA/EFTA countries, which was indirectly admitted by Hungary given the tax law changes described below.

Most probably because the proceedings regarding the above already started in 2007, the tax law modifications in effect from 1 January 2008 include the provision, that the tax incentive regarding R&D activities described above, also include similar institutions of the EU Member States, as well as the EEA/EFTA countries to the ones described earlier in the law. This change could be an indirect signal to the EU that Hungary is complying with the requirements set by the Commission. However, according to the procedural requirements, the Commission may refer the matter to the ECJ if it does not receive a satisfactory response from Hungary within 2 months.

According to the official viewpoint, Hungary has modified its tax legislation in order to comply with the above request and will confirm the reason for this modification by an official response to the Commission in order to clarify the issue.

-- Gabriella Erdős, Hungary; gabriella.erdos@hu.pwc.com

European Commission requests Portugal to end discriminatory taxation against investments held outside Portugal (case 2006/4696)

On 28 February 2008, the European Commission sent a formal request to Portugal to amend its tax legislation applicable to investments held through financial institutions established outside Portugal.

According to the law in force, capital income derived either from national or foreign source is subject to final withholding tax at a 20% rate. However, for certain categories of capital income derived from national or foreign sources which are put at disposal by financial

institutions established in Portugal, resident individuals can opt for taxation under progressive tax rates (that may vary between 10.5% and 42%).

In this context, individuals subject to a marginal tax rate lower than 20% will benefit from a lower taxation on income derived from investments made through financial institutions established in Portugal, compared to income derived from investments made through financial institutions established outside Portugal.

The Commission considers that the difference of treatment applicable to income derived from Portugal, comparing to income derived from other Member States, constitutes a restriction on the free movement of capital, foreseen in article 56 of the EC Treaty, as it dissuades resident individuals from making investments in other Member States.

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

-- Leendert Verschoor and Jorge Figueiredo, Portugal; jorge.figueiredo@pt.pwc.com

European Parliament issues report on impact of ECJ cases in field of direct tax

The Eurpopean Parliament's Policy Department for Economic and Scientific Policy has issued a comprehensive overview on the impact on the rulings of the ECJ in the area of direct taxation. The study was led by Prof. Malherbe of the Catholic University of Leuven. Click here for the full report.

-- Bob van der Made, The Netherlands; bob.van.der.made@nl.pwc.com

CCCTB - common consolidated corporate tax base

Commission issues two new Working Papers on anti-abuse and various detailed aspects of the CCCTB

The CCCTB Working Group had its thirteenth meeting on 14-15 April 2008. The meeting agenda included a discussion on the anti abuse working paper (WP65) and a discussion on various detailed aspects of the CCCTB (WP66).

Working paper 65

On 26 March 2008, the European Commission issued a working paper (WP65) which outlines possible anti abuse provisions.

It is proposed to bring in a general anti-abuse rule to allow tax authorities to re-characterise wholly artificial transactions justifiable by taxpayers producing evidence of a commercial justification. The Commission believe that a combination of general and other more specific anti-abuse provisions would enable tax administrations to combat specific and well known cases of abuse as well as other abuse that is not foreseen when designing the common rules.

More specific anti-abuse provisions include thin capitalisation and CFC. In designing the thin capitalisation provisions several aspects will need to be defined e.g. either EBIT or EBITDA and the establishment of the interest deductibility thresholds must be decided. The thresholds that have been established by Member States are around 80% if EBIT is chosen or around 25-30% if EBITDA is applied. We expect the Member States to favour the EBITDA formula as it is more common to use this formula rather than EBIT.

As regards CFC provisions the Commission believe that in order to comply with ECJ law either CFC rules are only to be applied in relation to third countries or CFC rules are also to be applied within the EU but, in this case, the rules should be targeted at wholly artificial arrangements only. It is the Commission's view that the CFC should be defined considering the nature of the income earned by the company i.e. if a certain threshold of the total income earned by the company is passive income (e.g. 80%) the company would be a CFC. Once the CFC is identified only the passive income should be integrated in the tax base of the resident company and when the CFC distributes dividends it would be assumed that the dividends are firstly paid out of the passive income. A definition of passive income has not yet been provided by the Commission.

Other anti abuse rules dealt with in the WP include a provision to avoid the abuse of the consolidation rules in connection with the participation exemption. The problem was addressed in WP57 which proposes that "gains realised on the disposal of such shares would not be exempt to the extent that assets were transferred to the departing company within the present or previous tax year and their disposal would have triggered a gain". However some Member States have said that the period of two years is too low and therefore too easy to manipulate.

The Commission posed a number of questions to the Member States including whether a general anti-abuse rule should be established, whether they agree with the interest deductibility thresholds of EBIT and EBITDA, whether they agree a switch over rule on third country dividends is necessary and if they consider that there is a need to design rules to avoid the manipulation of the factors in the Formulary Apportionment.

Working Paper 66

Working Paper 66 issued on 27 March 2008 addresses various detailed aspects of the CCCTB. This paper suggests that a tax principles clause regarding the "bridge" between national GAAP/IFRS if permissible should be included.

'The tax base shall be computed in accordance with the following general principles unless otherwise stated:

- The accruals principle
- Profits and losses shall only be recognised when they are realised.
- Transactions and taxable events shall be measured individually.
- The calculation of the tax base shall be carried out in a consistent manner unless exceptional circumstances justify a change.'

Other items addressed include the value at which the assets of the company enter the CCCTB. The Commission are in favour of the assets of the company entering at their tax written down values calculated according to domestic tax law.

There is also further discussion of “joiners” and “leavers” and the related sales and valuations.

A clear definition of “local” taxes to be deducted only from the Member State allocated share of the CCCTB base is also requested.

-- Peter Cussons and Avril Bates, United Kingdom; peter.cussons@uk.pwc.com

STATE AID

Italy – Commission decides that the 2003 Italian tax scheme on the recognition of hidden capital gains of privatised banks constitutes State aid

The 2003 Italian tax scheme, allowing former publicly owned banks to tax the capital gains arising from their privatizations by means of a 9% substitute tax (instead of the 37.25% ordinary company tax), was declared by the European Commission to constitute State aid, within the meaning of article 87(1) of the EC Treaty, incompatible with the common market.

In the 1990s the privatisation of the banking system took place in Italy. This process was realised through the contribution of the assets of the formerly state-owned banks into publicly 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”).

Law no. 218 of 1990 on the privatisation of the Italian State-owned banks provided for, at Article 7(2), 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.

On 24 December 2003, the Italian Parliament enacted Law no. 350 of 2003 (so-called Financial Law for 2004), which at Article 2(26) provided for that capital gains resulting from these privatisations could be released by paying a substitute tax of 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 abovementioned Law also established that the substitute tax was payable in three instalments (50% in 2004, 25% in 2005 and 25% in 2006), without interest payment.

According to the Commission, the tax scheme laid down in Article 2(26):

- granted to certain banks an advantage represented by the difference between the tax effectively paid to realign the value of the property (12% or 9%) and the tax which would have been normally paid in the absence of the abovementioned provision (37.25%, i.e. 33% corporate tax and 4,25% regional business tax);
- granted an advantage attributable to the State as it resulted in a reduction of the tax revenues normally collected by the Italian Tax Authorities;
- was a selective measure as limited solely to the banks concerned with the reorganisations governed by Law 218/1990;
- distorted competition, strengthening the financial position and the competitiveness of the beneficiary banks in the EU common market of financial services.

On the basis of such an analisys, the Commission concluded that the 2003 tax scheme constitute a State aid incompatible with the Common Market. As Italy failed to notify the scheme to the Commission before its implementation, the aid illegally granted must be recovered from its beneficiaries. The Commission limited the recovery to the difference between the tax actually paid and the tax the beneficiary banks would have paid in the case of application of the general tax revaluation scheme provided for by Article 2(25) of the same Financial Law for 2004.

According to the information provided by the Italian authorities, nine banking groups applied the unlawful tax scheme, paying about 180 million Euro for the recognition of their capital gains amounting to more than 2 billion Euro. The Commission requested Italy to recover an estimated amount of 123 million Euro from the nine beneficiaries.
See also EUDTG Newsletter Issue 2007 - nr. 004.

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Italy – Commission refers Italy to the ECJ for failure to recover a State aid in favour of companies participating in trade fairs abroad

Italy has been referred by the European Commission to the ECJ for failing to comply with the Commission decision of 14 December 2004 providing for that the 2004 tax incentive in favour of companies taking part in trade fairs abroad constitutes a State aid incompatible with the common market and ordering its recovery from the beneficiaries.

By means of Law no. 326 of 2003, the Italian Parliament approved an exceptional tax scheme providing that any company liable to corporate income tax in Italy could reduce its taxable income by the amount of the expenses directly incurred with respect to the participation in trade fairs abroad. The same Law also provided that this reduction, related only to displaying products at trade fairs abroad, was applicable only in 2004 and in addition to the ordinary deductions provided for by the Italian Tax Code with reference to advertising, promotion and agency costs.

By decision dated 14 December 2004, the Commission declared that the 2003 tax scheme in favour of companies taking part in trade fairs abroad was incompatible with state aid rules. In fact, according to the Commission, the scheme:

- afforded the beneficiaries an advantage consisting in the reduction of their taxable income by an amount corresponding to the costs incurred through taking part in trade fairs abroad;
- afforded an advantage attributable to the State as it resulted in a reduction of the tax revenues normally collected by the Italian Tax Authorities;
- was a de facto selective measure because it appeared to benefit only companies engaged in exhibiting products for export, while excluding other business activities;
- distorted competitions because it has the effect of improving the trading conditions of Italian companies in foreign markets, including other Member States;
- and, therefore, was a State aid within the meaning of article 87(1) of EC Treaty.

The Commission also pointed out that the exceptions provided for in article 87(2) and (3) of the EC Treaty were not applicable to the measure under scrutiny.

The only part of the scheme which was found to be compatible with existing state aid rules concerned the aid granted to SMEs not exceeding 50% of the costs arising from their first participation in a fair exhibition with respect to a new market, as the aid is allowed by Article 5(b) of Regulation no. 70/2001/EC.

Finally, as Italy failed to notify the scheme before its implementation, the Commission ordered the recovery of the illegal and incompatible aid from the beneficiaries.

On the basis of the abovementioned decision, the Italian Authorities adopted specific measures to recover the aid from the beneficiaries. More precisely, pursuant to Article 15 of Law no. 29 of 2006, the beneficiaries were required to file a tax return to declare the amount of the costs deducted as a consequence of the application of the unlawful scheme and to pay back the relevant aid they benefited from. In the case of non-compliance with the abovementioned obligations, the Italian Tax Authorities could request the not recovered aid by means of recovery injunctions. Up to today the aid has not been fully paid back because in several cases the beneficiaries appealed against the recovery injunctions issued by the Italian Tax Authorities and national courts decided to suspend their execution.

The Commission, therefore, concluded that the measures adopted by the Italian Authorities were not sufficiently effective to ensure compliance with the negative decision it issued and decided to refer the matter to the ECJ according to the procedure laid down in article 88(2) of EC Treaty.

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Update on EU-Swiss dialogue on disputed Swiss company tax regimes

On 8 April 2008, representatives from Switzerland and the EU resumed their dialogue in Berne on the EU's assessment of certain corporate tax rules. The EU considers these tax rules to be state aid and incompatible with the Free Trade Agreement between Switzerland and the EU of 1972 (FTA). The parties still agree to disagree.

The Swiss delegation emphasised its point of view according to which the FTA is not applicable to the cantonal tax rules in question and that these corporate tax rules do not constitute state aid nor distort cross-border competition as they are available to all companies in Switzerland which have no or at most subordinate domestic business operations (which are taxed normally). In addition, the working of holding company taxation was discussed in detail. The Swiss delegation considers these rules not to be discriminatory as domestic and foreign revenues are being taxed the same way.

Remarkably, the delegations seemed to find a closer understanding this time and did not fix a precise date for a next meeting. As the working group which the Swiss government has put in place in order to formulate proposals for corporate tax reforms is expected to present its findings in the autumn, a new meeting between the two delegations is likely to take place at a later time. In addition, leading Swiss members of parliament have suggested to amend the disputed tax rules by extending the lower tax rates to domestic income as well. In a first reaction, the EU's ambassador in Switzerland has welcomed the idea saying that it could resolve most of the problems.

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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 EC 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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