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ECJ CASES

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On 15 February, Advocate General (AG) Kokott opined on the compatibility of a Flemish inheritance tax relief. Since an inheritance tax on controlling interests in family companies could threaten the continuation of those undertakings following the death of the director, the Flemish Region of Belgium exempts such shareholdings. This exemption is however only granted if the undertaking employed at least 5 workers in Flanders in the 3 years prior to the death of the deceased.

According to the AG, the provision essentially relates to the freedom of establishment and needs to be assessed according to that criterion alone. Although there is no direct discrimination on the basis of nationality, the contested provision favours only interests in companies which continuously employ five workers in the Flemish Region, thus treating them more favourably than interests in undertakings which do not meet this criterion. In most cases, only those undertakings which are established in the Flemish Region fulfil the condition as to employment of workers in that region. Therefore a rule such as the contested provision relating to inheritance tax constitutes a restriction on the freedom of establishment. The Belgian Federal Government could not provide any justifications for the restriction. See also EUDTG Newsalert NA 2007 – 007.

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

Belgium – European Commission refers Belgium to the ECJ over discriminatory Flemish registration tax levied on the purchase of houses

On 8 January 2007, the European Commission announced that it had referred Belgium to the ECJ with respect to its discriminatory rules on the Flemish registration tax levied on the purchase of houses in Flanders. According to the Flemish registration tax rules, individuals who purchase a house in Flanders receive a credit for the registration tax paid earlier on another house, provided that the house was also situated in Flanders. In contrast, EU citizens who move from another Member State to Flanders and buy a house do not receive such a credit for the registration tax which they have paid on the purchase of a house in their Member State of origin.

The Commission had already sent a Reasoned Opinion to Belgium on 20 July 2006, to request the termination of this discrimination (2005/2283). Belgium, however, was of the opinion that the situations of a Flemish resident in contrast to a non-resident of the Flanders region were incomparable. Therefore no limitation of the free movement of capital was at hand according to the Belgian government. As the Commission was not satisfied with the Belgian response, it has referred Belgium to the ECJ.

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

Belgium – European Commission refers Belgium to the ECJ for its discriminatory taxation of inbound dividends

The European Commission announced on 22 January 2007 that it had decided to refer Belgium to the ECJ for its discriminatory taxation of inbound dividends, which according to the Commission, restricts the free movement of capital and/or the freedom of establishment provided for in the EC Treaty and the corresponding provisions of the EEA Agreement.

Belgian private investors receiving domestic dividends either pay a final tax withheld by the company or they are taxed at a special income tax rate of, in principle, 25%. Inbound dividends are first subject to a withholding tax of up to 15% in the source State on the basis of the double taxation agreement between Belgium and that State, and then suffer Belgian income tax at the special income tax rate of 25% without getting a credit for the foreign tax. The result is that inbound dividends are taxed more heavily than domestic dividends.

The higher tax burden is a restriction in the sense of Article 56 EC. In so far as the shareholding gives the shareholder control over the company it is also a restriction of the freedom of establishment of Article 43 EC. The same holds for the corresponding articles of the EEA Agreement.

According to the Commission, the EC Treaty obliges the Member States to apply the same system that they use to avoid double taxation on domestic dividends to inbound dividends. When drafting the application to the ECJ, the Commission has said that it will take into account the ruling by the ECJ in Kerckhaert-Morres case (C-513/04). The Commission's case reference number is 2005/4504.

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Denmark – AG opinion on possibility for Member States to prevent tax avoidance under Merger Directive: Hans Markus Kofoed v Skatteministeriet case (C-321/05)

On 8 February 2007, the AG opined on the preliminary issue of whether Article 2(d) of the Merger Directive has to be interpreted as meaning that there is no exchange of shares within the meaning of that directive where the persons involved in the exchange of shares, at the same time as agreeing to exchange the shares, in a non-legally binding manner, declare it to be their common intention to vote at the first general meeting of the acquiring company after the exchange in favour of distributing a profit in excess of 10% of the nominal value of the security transferred by way of the exchange of shares and such a profit is in fact distributed.

The case concerned a transaction in which two Danish taxpayers transferred their shares in a Danish company to an Irish company and in return acquired shares in the Irish company. A few days later, as planned from the outset, the Irish company effected a distribution of profits in favour of the two Danish taxpayers.

Both the exchange of shares and the resolution concerning the distribution of profits were effected shortly before the entry into force of a new Danish-Irish double taxation convention, by which it was intended to introduce less favourable rules on the taxation of dividends than those applying to Danish taxpayers under the convention in force at that time.

The AG held that payments of money, for example, profit distributions, effected by an acquiring company, not agreed in a binding manner as consideration for the holding by which that company acquires a majority of the voting rights in the acquired company, are not included within the concept of a cash payment within the meaning of Article 2(d) of the Directive, even if those payments were from the outset planned by the parties and were effected at a time closely connected to the acquisition of that holding.

The AG also concluded that neither direct application of Article 11(1)(a) of the Directive which deals with abuse leading to the detriment of an individual nor direct recourse to a general Community prohibition on the misuse of law is permitted. See also EUDTG Newsalert NA 2007 – 004.

-- Birgitte Tabbert and Soren Jesper Hansen, Denmark; sjh@pwc.dk

Denmark – ECJ judgement on deductibility of pension contributions: Commission v Denmark case (C-150/04)

On 30 January 2007, the ECJ held that Denmark has failed to fulfil its obligations under EC Law by introducing and maintaining in force a system for life assurance and pensions under which tax deductions and tax exemptions for payments are granted for payments under contracts entered into with pension institutions established in Denmark, while no such relief is granted for payments under contracts entered into with pension institutions established outside Denmark.

Danish legislation on the taxation of pension contributions is currently divided into 2 parts. Part 1 of the legislation essentially states that contributions made to a Danish pension scheme are either deductible or exempted for the purposes of calculating taxable income, but the growth of the pension fund is taxable. However, to qualify for part 1, the pension fund must, among other requirements, be established in Denmark. On this basis pensions held outside of Denmark immediately fall under part 2 of the legislation, under which no deductions or tax relief are granted on contributions, while the growth of the fund is not taxed provided a number of other conditions are fulfilled. See also EUDTG Newsalert NA 2007 – 002.

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Finland – Referral to the ECJ on the protection of individuals in personal tax data processing: Satakunnan Markkinapörssi and Satamedia case (C-73/07)

The Finnish Supreme Administrative Court has referred a case concerning the interpretation of EU Directive 95/46/EC on the protection of individuals with regard to the processing of personal data and on the free movement of such data to the ECJ. The case concerns a company which published annually personal tax data of Finnish individuals in local newspapers. The company also released such data to another company for SMS service purposes. The information in the local newspapers was available by SMS service for payment. The Court has asked the ECJ whether activities, including collection, publishing, releasing, and processing income and wealth tax data is considered to be personal data processing meant by the Directive and whether these activities are performed in accordance with the Directive.

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France – Referral to the ECJ on the application of the Parent-Subsidiary Directive to the taxation of 5% of EU gross dividends

On 17 January 2007, the French Supreme Court referred a question to the ECJ on the application of the Parent-Subsidiary Directive to the taxation of 5% of EU gross dividends.

Under French law, the taxable base of a dividend received from an EU subsidiary (which qualifies under the affiliation privilege) amounts to 5% of the dividend received in cash, increased by the amount of the tax credit withheld at source. No issue arises when the French parent can offset such tax credit, for instance, against the equalisation tax due ("précompte") upon redistribution of such dividends.

However, where the parent is not in the position to effectively offset the tax credit, the question arises whether the taxation of 5% of the tax credit itself is permitted under article 7, section 2 of the Parent Subsidiary Directive, considering that this taxation has been introduced in direct connection with the tax credit system preventing double taxation, or whether it should be considered as in breach of article 4 of the directive, which caps the taxation to 5% of the profits distributed by the subsidiary. The Supreme Court referred that question to the ECJ.

-- Jacques Taquet and Franck le Mentec, France; jacques.taquet@fr.landwellglobal.com

Germany – ECJ judgement on deduction of expenses in the Source State: Centro Equestre de Leziria Grande Ltd case (C-345/04)

Centro Equestre is a Portuguese resident corporation that tours with equestrian shows. In 1996, one tour took place in Germany. Centro Equestre was taxed on the German proceeds as a non-resident with a final withholding tax on the proceeds. If the expenses with a direct economic connection to the proceeds exceed 50 % of these proceeds, non-residents may apply for a (partial) tax refund. The taxpayer thereby accepts that his residence state is notified of the tax reduction. A refund can be granted insofar as the tax exceeds 50 % of the proceeds less directly related expenses. Centro Equestre also applied to have indirect expenses, e.g. proportionate personnel costs, write-down of horses etc. considered. This was rejected since the expenses were not *directly* economically connected with the proceeds (for prior coverage, see Newsalerts NA 2006 – 015.and NA 2007 – 006.).

In its judgment on 15 February 2007, the ECJ stated that the condition of a *direct economic connection* between income and expenses is generally *not* in breach of Article 49. According to previous case law, it is clear that the territoriality principle does not preclude Member States from taxing non-residents only for profits and losses arising from the activities in that State. Since residents and non-residents are in comparable situations concerning operating expenses directly connected to activities pursued in that Member State, these must be equally deductible for residents and non-residents. The ECJ considered that only expenses with a direct economic connection to the provision of services in the source state, which are inextricably linked to those services have to be deductible for non-residents. The place and time at which these expenses are incurred are immaterial. The ECJ left it to the German Court to decide which of the claimed expenses were inextricably linked to the services taxed in Germany, as this is a question of facts.

However, the ECJ held the second requirement, i.e. the "50 %-threshold" to be an infringement of Article 49 EC, since a company cannot automatically obtain a reduction of tax if it has expenses directly connected with the economic activity concerned. See also EUDTG Newsalert NA 2007 – 006.

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Germany – ECJ judgement on imputation credit on foreign dividends and on limitation of the temporal effects of ECJ judgments: Meilicke case (C-292/04)

Mr. Meilicke, a German resident individual, received dividends from Dutch and Danish companies in 1995 through 1997. The heirs of Mr. Meilicke applied unsuccessfully for an imputation credit, as the former German imputation system - abolished in 2000 - only allowed for an imputation credit on dividends from German companies (for previous coverage, see EU Tax News Issues 2006 - nr. 001, 003 and 006 as well as Newsalert NA 2007 – 008).

In its judgment on 6 March 2007, the ECJ confirmed its previous case law regarding the material issue of imputation credit on foreign dividends (cf. ECJ judgment on the more or less identical Finnish imputation system *Manninen (*C-319/02) of 7 September 2004). The rules of the former German imputation system constitute a breach of the free movement of capital as far as Germany granted an imputation credit only on dividends paid by German resident companies. The German imputation credit was computed by reference to the underlying corporation tax on the distributed dividend. The same should, according to the arguments of the ECJ, apply to the credit on foreign dividends, even if the foreign underlying corporation tax is higher than the German imputation credit.

Furthermore, the ECJ rejected Germany's application for a limitation of the temporal effects of the judgment. Clarifying the issue of a limitation of temporal effect, the ECJ stated that there must be *one* single occasion when a decision is made on the temporal effects of the interpretation on EC Law. The principle that a temporal restriction is only allowed in the *actual judgment ruling on this interpretation* ensures legal certainty and that all Member States and other subjects of EC Law are treated equally. The *Meilicke* case concerns the tax treatment that a Member State has to accord to foreign dividends. The *Verkoojen* case of 2000 already dealt with the requirements arising from the free movement of capital in respect of foreign dividends received by residents. Since the temporal effects of that judgment were not limited and, additionally, the principles in Verkoojen were confirmed e.g. in the *Manninen* judgment, the ECJ did not find it appropriate to limit the temporal effects of the *Meilicke* judgment.

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Germany – ECJ judgement on joint filing for spouses resident in different Member States: Meindl case (C-329/05)

Mr. Meindl, an Austrian citizen resident in Germany, had German income of DEM 138,422 in 1997. His Austrian resident spouse received a tax exempt maternity allowance of DEM 26,995 from Austria. They applied for joint filing in Germany to benefit from the split tax rate. This was rejected, since joint filing where one spouse is non-resident requires that - calculated according to German law - at least 90 % of the aggregate income is subject to German tax, or the income not subject to German tax does not exceed DEM 24,000. None of these requirements was fulfilled, as German tax law only exempts *German* as opposed to *Austrian* maternity allowances from taxation and the allowance exceeded both 10 % of the aggregate income as well as DEM 24,000 (for prior coverage, see EU Tax News Issue 2005 - nr. 003 and Newsalert NA 2007 – 001).

In its judgement on 25 January 2007, the ECJ held that Mr. Meindl, who worked and lived in Germany and whose unemployed spouse lived in Austria and only received income not subject to tax there, was in an objectively comparable situation with a German resident taxpayer, whose unemployed spouse resided in Germany and only received income not subject to tax in Germany. In both cases, the aggregate taxable income originates from the professional activity of one spouse and in both cases, that spouse is the relevant taxpayer. In that regard, Mr. Meindl is treated differently from a taxpayer whose spouse is a German resident. The requirement of German residency for the unemployed spouse, which is the basis for the different treatment, is more likely to be fulfilled by German nationals.

The ECJ accordingly stated that this is a discrimination prohibited by Article 43 EC and not justifiable since Mr. Meindl is in no way entitled to have his personal and family circumstances taken into account. As already ascertained in previous case law, this account can only be taken by the state of residence when a taxpayer receives the entire income of the household there.

Finally, having regard to earlier case law, the ECJ pointed out that the 90 %- or DM 24.000-limits are as such not contrary to EC Law, as long as there is a possibility to take the spouses' personal and family circumstances into account in the state of residence.

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Netherlands – Referral to the ECJ on transfer tax upon inheritance by a non-resident: the Arens-Sikken case (C-43/07)

According to the Dutch Inheritance Tax Act a transfer tax is payable when certain domestic assets, e.g. real estate, pass by inheritance from persons whose last place of residence was outside the Netherlands. In the present case the testator was a resident of Italy. He had assigned all of his assets and liabilities to his wife, Ms Arens-Sikken, under the obligation to pay out to their four children their portions at a certain moment in the future. The inheritance included a private dwelling situated in the Netherlands. Ms Arens-Sikken was assessed for the value of this dwelling. She could not deduct the debts owed to her children with respect to the aforementioned obligation. A deduction would have been possible if the testator had lived in the Netherlands. The question arises to what extent this difference constitutes a restriction of the free movement of capital enshrined in Article 56 EC. More specifically, it is unclear whether the *Schumacker*-doctrine is applicable or that only costs which are directly related to the Dutch part of the inheritance should be taken into account in the Netherlands (cases of *Barbier*, *Gerritse* and *Bouanich*). In addition, it should be noted that the grant of a deduction by the Netherlands would not necessarily put Ms Arens-Sikken in a better position. After all, Italy would allow a credit for the tax payable in the Netherlands, as a result of which a deduction in the Netherlands may result in a correspondingly higher taxation in Italy. The Dutch Supreme Court has now referred the case to the ECJ (HR 12 January 2007, nr. 39.819).

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Netherlands – Referral to the ECJ on treatment of negative income from an owner-occupied dwelling in the state of employment: the Renneberg case (C-527/06)

Mr Renneberg has the Dutch nationality. In 1996 and 1997, he was a resident of Belgium and employed by a Dutch municipality. He had no other significant positive income. The tax inspector has refused to deduct from the Dutch employment income the negative income from Renneberg's Belgian private dwelling. Although Renneberg is regarded as a resident taxpayer for Dutch income tax purposes – he is a Dutch national in public service – the tax treaty between Belgium and the Netherlands says that the negative income from the private dwelling may be taxed in Belgium only. As a consequence, this negative income cannot be taken into account in the Netherlands (settled case law of the Dutch Supreme Court). Renneberg, however, argues that this rule infringes Community law (Articles 18, 39 and 56 EC). The Dutch Supreme Court has now decided to refer the case to the ECJ (Renkema: HR 22 December 2006, nr. 39.258**)**

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Sweden – ECJ judgement on tax deferral for capital gains on private residential property: Commission v Sweden case (C-104/06)

On 18 January 2007, the ECJ ruled that the Swedish provisions regarding tax deferral for capital gains on private residential property are incompatible with EC Law.

Swedish tax provisions allowed for a deferral of taxation on capital gains realised on the sale of a residence occupied by its owner when a new residence was acquired, however only if the newly acquired residence was situated in Sweden. The European Commission initiated an infringement procedure against Sweden on account of these discriminatory provisions. As Sweden did not change the provisions in order to comply with the Commission's Reasoned Opinion, the Commission referred the case to the ECJ.

The ECJ held that the rules which make the entitlement to deferral of taxation on capital gains arising from the sale of a private residential property conditional on the newly-acquired residence also being on Swedish territory imply that Sweden has failed to fulfil its obligations under Articles 18, 39 and 43 of the EC Treaty and under Articles 28 and 31 of the EEA Agreement.

Sweden has already amended the rules (applicable as from 1 February 2007) and foreign original dwellings and foreign replacement dwellings are now covered by the capital gains tax deferral.

-- Gunnar Andersson, Sweden; gunnar.andersson@se.pwc.com

Sweden – Referral to the ECJ on Pension Insurance Issues

The European Commission recently referred Sweden to the ECJ for its discrimination against foreign pension funds (case reference number 2005/4348). The background is the specific Swedish tax treatment for pension insurance, which required that the insurer is Swedish. The European Commission had already earlier in a reasoned opinion, without any effect, noted that these Swedish rules were restrictive. The referral to the ECJ argues that the Swedish rules restrict the free movement of persons, services as well as capital. In this respect it should be noted that only weeks thereafter, the Swedish Government announced the immediate introduction as per 2 February of new tax rules in this respect, whereby the specific pension insurance treatment instead requires that the insurer is EEA resident. The pretext of these changes was however the recent ECJ-case regarding Denmark (C-150/04) of 30 January 2007, where similar Danish rules were found incompatible with EC Law.

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Miscellaneous – European Commission refers Belgium, Spain, Italy, Netherlands and Portugal to the ECJ for their discriminatory taxation of outbound dividends

On 22 January 2007, the European Commission decided to refer Belgium, Spain, Italy, the Netherlands and Portugal to the ECJ. The tax rules of these countries in some cases lead to higher taxation of outbound dividends than of domestic dividends. While they provide for no or only very low taxation of domestic dividends, outbound dividends are subject to withholding taxes ranging from 5% to 25%. The Commission considers that these rules are contrary to the EC Treaty and the EEA Agreement, as they restrict both the free movement of capital and the freedom of establishment. The Commission had already sent a Reasoned Opinion to Belgium, Spain, Italy, the Netherlands and Portugal on 25 July 2006 requesting them to change their legislation. Latvia was also formally requested to amend its tax legislation concerning outbound dividend payments to companies. As regards Belgium, Spain, Italy, Latvia and Portugal, the discrimination concerns outbound dividends paid to Member States and to those EEA/EFTA countries which provide appropriate assistance (i.e. exchange of information). For the Netherlands it only concerns the latter countries.

In its press release, the Commission refers to the ECJ's *Denkavit* judgement of 14 December 2006 (C-170/05) in which the Court confirmed the principle that outbound dividends cannot be subject to higher taxation in the source State (the State where the subsidiary is established) than domestic dividends. With this in mind, the Commission stated that it may still be relevant however to take into account whether the State of residence of the parent company gives a tax credit for the withholding tax levied by the source State. Up to now, the Commission followed the same approach as the EFTA Court in the *Fokus Bank* case (Case E-1/04), where it explicitly ruled that it was not relevant whether a tax credit was given in the residence State.

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NATIONAL DEVELOPMENTS

Finland – First deadline for Lex Manninen refund claims to close on 30 April 2007

In the aftermath of the *Manninen* judgement (C-319/02), the Finnish Government implemented a new Act for the refund of taxes paid on dividends received from the EEA (hereinafter the "Lex Manninen"). The Lex Manninen enables the rectification of EEA-source dividend taxation for the benefit of Finnish resident taxpayers. The term for applying for refunds of excess taxes paid expires for the first time on 30 April 2007, and it concerns fiscal years 1998-2000. Refund applications for 2001 can be filed until 31 December 2007. The rectification applies to dividends received and taxed during fiscal years 1998-2004. As a result, the excess amounts of taxes paid in Finland are refunded to taxpayers via a separate refund application procedure (the standard refund form is provided by Finnish Tax Authorities). Individual taxpayers receiving dividends from three big exchange-listed companies Nordea AB, TeliaSonera AB, and Danisco A/S are refunded automatically.

Until 2004, Finland applied an imputation credit system, whereby a Finnish resident dividend recipient was entitled to an imputation credit, but only from dividends distributed by a Finnish resident company. The *Manninen* judgement declared such a system incompatible with the EC Treaty and as a compensatory measure, the Lex Manninen was enacted.

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France – Non-compatibility with EU law of French "avoir fiscal" and "précompte"

The lower administrative Court of Versailles held on 21 December 2006 that the avoir fiscal and equalisation tax ("précompte") related to French source dividends qualifies as a restriction on the free movement of capital set out in Article 56 EC Treaty. The rationale is that contrary to French source dividends, no "avoir fiscal" is attached to dividends received from EU subsidiaries which have been subject to CIT in their home country, and consequently no "avoir fiscal" can be offset against equalisation tax due when such foreign source dividends are in turn redistributed by the French parent. Following the ECJ's 2004 judgement in the *Manninen* case, the French Parliament abolished "avoir fiscal" and the "precompte" tax system as from 2005.

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Germany – German CFC Taxation after the Cadbury Schweppes decision

On 12 September 2006, the ECJ decided in the Cadbury Schweppes case (see NA 2006-022) regarding the UK CFC rules. It ruled that Art. 43 EC precludes the inclusion in the tax base of a resident company established in a Member State of profits made by a controlled foreign company in another Member State, where those profits are subject in that State to a lower level of taxation than that applicable in the first State, unless such inclusion relates only to wholly artificial arrangements. Accordingly, such tax measure must not be applied where it is proven, on the basis of objective factors which are ascertainable by third parties that the controlled company is actually established in the host Member State and carries on genuine economic activities there.

On 8 January 2007, the German Ministry of Finance issued a circular intended to enable the tax authorities to apply the German CFC legislation in accordance with the above-mentioned jurisprudence. Accordingly, income and gains derived by entities having their legal seat or their place of management within the EU/EEA and earned by the latter in these territories shall be excluded from German CFC taxation if the foreign subsidiary meets the following conditions:

- the company participates actively, permanently and sustainably in the market activities in the Member State where it has its seat or its place of management with its own trade or business;
- the company employs, in the Member State where it has its seat or place of management, both managing staff as well as other personnel for the purpose of carrying out its business activities;
- the company's staff is qualified to carry out the functions taken on by the company independently and self responsibly;
- the income of the company originates from its own trade or business;
- if the company predominately deals with related parties, the activities of the company must add value for the related party and the capitalization of the company is reasonable in relation to that added value.

This suspension of the CFC legislation does not apply to Liechtenstein, the only Member State of the EEA not providing mutual assistance in tax matters to Germany. It shall further only apply to those cases where the German shareholder has a majority shareholding - alone or together with related parties - in the foreign subsidiary.

The German tax administration's requirements for an actual establishment in the Host State are rather strict. It remains to be seen, whether they will hold, should a corresponding case be taken to the ECJ.

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Ireland – Amendments to Irish group relief provisions

In response to the ECJ decision in the Marks & Spencer case, amendments have been made to the Irish group relief provisions to provide, in certain circumstances, loss relief for trading losses incurred by EU/EEA resident subsidiaries for accounting periods ending on or after 1 January 2006.

The loss must be a "trapped loss", must not be available for relief in the surrendering country and can only be utilised by an Irish parent of the surrendering company. The loss must also be available for relief under Irish rules if the foreign company were Irish resident. Anti-avoidance measures provide that no relief is available if the foreign loss arose as a result of a scheme or arrangement whose purpose was to secure that the loss would qualify for group relief.

-- Anne Fitzgerald and Anne Harvey, Ireland; anne.fitzgerald@ie.pwc.com

Ireland - Amendments to Ireland's patent royalty exemption

Ireland's Finance Bill 2007 is currently making its way through Parliament and is due to be enacted into Irish law by 6 April 2007. An unexpected amendment was announced recently, setting out important changes in relation to Ireland's patent royalty exemption. The proposed changes should bring the patent royalty exemption in line with EU principles, and will apply to patents developed on or after 1 January 2008.

Currently, Irish tax legislation provides that Irish residents may be exempt from tax on all royalty income from "qualifying patents". The patents do not have to be registered in Ireland but substantially all of the work on the development and testing of the patented process must have been undertaken in Ireland. The tax exemption is available only in respect of income derived from the use of the patent by a manufacturing company or by an unrelated third party.

The proposed legislation extends the scope of the patent exemption while putting a monetary ceiling on the annual amount of exempt income. The legislation does not extend the exemption to EU residents who carry on an activity in Ireland through an Irish PE.

The detailed changes are as follows:

- The definition of a "qualifying patent" is being extended to include a patent in respect of an invention for which the research, planning, processing, experimenting, testing, designing, developing or similar activity which is the subject of the patent has been carried out in an EEA State. This means that the work can be undertaken in any of the EU-27 Member States, Iceland, Liechtenstein or Norway and the related patent royalties will be tax exempt in Ireland.

- A monetary limit of EUR 5 m has been placed on the aggregate amount of exempt patent income arising to a person (including any connected persons) in each 12 month period commencing on or after 1 January 2008. At present there is no limit.

Whilst driven by EU principles, the extension of the exemption to include EEA (rather than just Irish) innovation activities, make Ireland an interesting location from which to exploit patents. However the monetary limit will likely mean that the new provisions will be of most interest to early stage businesses and individual inventors.

-- Anne Fitzgerald and Anne Harvey, Ireland; anne.fitzgerald@ie.pwc.com

Ireland – Implements the European Company Regulation (Societas Europaea)

Ireland implemented Council Regulation (EC) No 2157/2001 in January 2007 into Irish law.

-- Anne Fitzgerald and Anne Harvey, Ireland; anne.fitzgerald@ie.pwc.com

Italy – Amendments to the domestic Implementation Law for Interest and Royalties Directive

On 15 February 2007, the Italian government issued a Law Decree in reply to the European Commission's formal request to amend the Legislative Decree no. 143/2005, which implements the Interest and Royalties Directive (Directive 2003/49/EC of June 2003).

On 9 January 2007, the Commission had sent Italy a formal request in the form of a Reasoned Opinion considering that the implementation Law restricted in an unjustifiable way the scope of the application of the Directive.

In this respect, the aforementioned Legislative Decree provided for the application of the Directive only to interest and royalty payments accrued *on or after* 1 January 2004, excluding any interest and royalty accrued *before* but paid on or after that date (as requested by the Directive).

The purpose of this restriction was to avoid the postponement of payments with the only intention of taking advantage of the better tax treatment provided for by the Directive (which establishes, under certain conditions, the taxation of these payments in the State of residence of the beneficial owner, abolishing any withholding tax in the source State). The Commission considered the measure to be disproportionate to the achievement of that purpose.

In reply to the Commission's request, the Italian government issued the abovementioned Law Decree, which amends the Legislative Decree, changing the wording: "interest and royalty *accrued* on or after 1 January 2004" into: "interest and royalty *paid* on or after 1 January 2004".

The Law Decree also establishes that the withholding tax unduly levied can be reimbursed to non-resident companies by the Italian paying agent, who will recover the amount paid from the Italian Tax Authorities offsetting it against any other tax debt or social contribution.

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Latvia – M&S- type cross-border loss relief provisions

Apparently in response to the ECJ decision in the Marks & Spencer case of 13 December 2005 on cross-border loss relief, the Latvian Ministry of Finance has incorporated similar group relief provisions in the Latvian Corporate Income Tax (CIT) Act.

A Latvian company can claim a foreign company's tax loss if the following conditions are met:

- The foreign company is registered in a country with which Latvia has a tax treaty or in an EU/EEA country.
- The foreign company forms a qualifying tax group under Latvian law
- The foreign company has no tax arrears in its country of incorporation.

- The foreign company is neither exempt from foreign CIT nor eligible for a reduced rate nor for any other CIT relief;
- The Latvian company received confirmation from the foreign tax authorities that:
- the foreign company is a member of the particular group;
- the tax losses were made in the particular tax period;
- the tax losses cannot be offset in subsequent or previous tax periods or used by another taxpayer in the particular country.

According to the ECJ ruling in Marks & Spencer, the parent company may use its subsidiary's tax losses if the foreign subsidiary cannot use the losses in its country of residence and if the foreign subsidiary cannot transfer its tax losses to another group company in its country of residence.

The key difference with Latvian law is that group relief is available to, say, a Latvian fellow subsidiary and a subsidiary's subsidiary as well as to the parent company. Theoretically, this provision is very favourable for Latvian companies with related parties in other countries, which qualify as group companies that may use tax losses. Unfortunately, as it happens, this provision may only come into play in rare cases, i.e. when tax laws prevent a foreign company from transferring tax losses in its country of residence. Furthermore, Latvian CIT law states that a Latvian company within a group may use losses made by a foreign member in the current year. The tax laws of nearly all EU/EEA countries contain very extensive group relief provisions and, along with Latvian CIT law, specify a period (5–10 years) within which qualifying tax losses may be used.

Latvian companies are permitted to use foreign tax losses made in the current tax period only. Thus, a tax loss that a foreign company wishes to transfer to a Latvian company at the end of the above period may not be used under Latvian CIT law.

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Latvia – No withholding tax on outbound dividends

Recent amendments to the Corporate Income Tax Act have made it possible for more countries to claim exemption from withholding tax on outbound dividends from 1 January 2007. What was previously available only to EU companies has now been extended to EEA companies. Thus, dividends that a Latvian company pays to an EEA company with a 15% shareholding for at least 2 years are now exempt from withholding tax. Otherwise, 10% WHT applies. Although these conditions may not seem so harsh, Latvian companies receiving dividends from their Latvian subsidiaries 'unconditionally' benefit from exemption.

Following the European Commission's opinion of 22 January 2007, that such differential treatment is discriminatory, the Latvian government has announced plans to abolish these limits of 15% shareholding and 2 years. The draft amendments are not yet public.

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Netherlands – AG opinion on the interpretation of the anti-abuse provision in the EU Merger Directive

On 22 December 2006, the AG to the Dutch Supreme Court opined to refer preliminary questions to the ECJ on the interpretation of the anti-abuse provision in the EU Merger Directive.

In the framework of a business succession, it was envisaged to transfer the whole business, including a building, from A BV to B BV in exchange for shares. The shares of B BV were indirectly held by the father and the shares of A BV were directly held by the son. B BV's only asset consisted of a building, which was rented to A BV. In the (near) future A BV would buy the shares of B BV from the father. A BV applied for the business merger exemption for corporate income tax and transfer tax. The tax inspector refused to apply the merger exemption for corporate income tax.

Upon objection and appeal, the decision made by the tax inspector was confirmed. It was beyond dispute that both the merger of the buildings used for the business conducted by B BV and the business succession were based on sound business reasons. Nevertheless, the Court of Appeal held that there were no valid business reasons for the convoluted way through which the restructuring was to have taken place. According to the Court, the business succession could - in a straightforward way - have been realised by a sale of the building by A BV to B BV. Consequently, it was up to B BV to demonstrate that the merger did not have as its principle objective tax avoidance or deferral. As deferral of transfer tax and corporate income tax appeared to be the actual motive for the diversion, the Court ruled that the business merger exemption should not apply.

The AG doubts whether the decision of the Court of Appeal as well as the translation of Article 11 of the Merger Directive into Dutch law, are in line with the EU Merger Directive. According to Article 11, *tax avoidance* as the principle objective of a merger may be a reason to refuse the benefits of the Merger Directive. Under the Dutch merger exemption provisions, tax avoidance is translated as tax cancellation or *tax deferral*. As to the AG, it should be clarified whether tax avoidance as meant in Article 11 of the Merger Directive can also be interpreted as tax deferral. Furthermore, as the Merger Directive only extends to (corporate) income taxes, it is questionable whether the benefits of the Merger Directive may be refused if a merger has as its principle objective avoidance of taxes other than income taxes. Finally, it is not clear whether shareholders' motives are business motives as meant in Article 11 of the Merger Directive. According to the AG, the Supreme Court should refer preliminary questions to the ECJ on the aforementioned three subjects.

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Netherlands – New refund procedure for dividend withholding tax for foreign entities (including pension funds)

Per 1 January 2007, EU pension funds which are tax exempt in their Member State are granted the right to claim a full refund of the 15% Dutch dividend withholding tax levied on dividends distributed to these funds by companies resident in the Netherlands.

Based on the amended Art.10 of the Dutch dividend tax rules effective per 1 January 2007, refund requests for dividend withholding tax for foreign entities (pension funds) can now be submitted twice-yearly (i.e. every 6- months) in the Netherlands provided that the relevant (original) dividend vouchers are enclosed. The Dutch Finance Ministry published the new Dutch tax return that should be used to claim the refund on its website. An English version of the form is to follow soon.

PwC has been informed by the Dutch revenue service, that after receipt of the tax return, they will send a questionnaire to the claimant asking for proof that demonstrates that the claimant is compliant with the conditions set out in Art. 10. These (cumulative) conditions are:

- the claimant is a legal entity resident in another EU Member State;
- the profit of the legal entity is, in its state of residence, not subject to tax;

- the legal entity should not have been subject to corporate income tax in the Netherlands, had it been a resident in the Netherlands;
- the legal entity qualifies as the beneficial owner of the dividends.

Moreover they indicated that it is advisable - to ensure a swift dispatch of the refund request - not to await the aforementioned questionnaire, but to submit the following documentation accompanying the return:

- The Deed of Incorporation and Articles of Association (or similar documents)
- A description of the legal status of the entity (incl. comparability with a Dutch legal form)
- A letter from the foreign revenue service confirming the fund's exempt CIT status
- A justification of why the claimant would be exempted from Dutch CIT, had it been established in the Netherlands.

As we reported in July (Newsalert NA 2006 – 018) already and again in September 2006 (EU Tax News 005), the new refund procedure can be regarded as a next step by the Dutch government towards the non-discrimination of EU pension funds and companies receiving dividends from the Netherlands. This should be seen in the context of the complaint PwC has lodged together with the European Federation for Retirement Provision with the European Commission in December 2005 against 18 Member States including the Netherlands, and the ECJ's decisions that supported these complaints such as the *Amurta* case (C-379/05) and the *Denkavit* case (C-170/05).

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Norway – City court judgement on the statute of limitations on getting a refund of tax on inbound dividends

The insurance company Vesta AS had received dividends from different companies within the EEA from 1995 to 2003. The dividends from these countries were taxable at 28 % while dividends from Norwegian companies would in reality be tax free due to the imputation system.

On 30 January 2007, a Norwegian city court ruled that the Norwegian imputation system is in breach of the 1994 EEA Agreement. The city court stated that according to the tax assessment the main rule is a 10-years limitation and that the 3-year time limit could not apply in similar cases.

The city court finally ruled that the assessments for all of the aforementioned years should be suspended. In practical terms that means that the new assessment that the tax office must make will be in favour of the taxpayer, i.e. the taxpayer will get back NOK 56 millions.

However, the city court decision is appealed before the High Court. It is expected that this case, which will probably go up to the Supreme Court, will be decisive for all similar cases, both regarding inbound and outbound dividends.

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Norway – Decisions regarding refund of withholding tax claimed by Dutch Pension Funds

On 13 and 15 February 2007, the Norwegian COFTA (Central Office – Foreign Tax Affairs) issued two decisions in which it rejected the refund claims of two Dutch pension funds regarding Norwegian withholding tax on dividends The COFTA's reasoning is that the Pension Funds were exempt from taxation in the Netherlands, hence not protected by the EEA Agreement, and they were not covered by the tax exempt method which was introduced in 2004. The tax office had an even more surprising follow up argument, claiming that the Pension Funds, due to the exemption granted, could not be regarded as the real owner of the Norwegian shares. The decisions will be appealed to COFTA's superior board, which is the second and normally the last administrative level.

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Poland – New regulations on dividends

In order to eliminate double taxation of dividends received from abroad by companies based in Poland, the CIT Act stipulates that foreign dividends will be exempt from taxation in Poland. The exemption will only apply to dividends paid by selected companies in the EU, EEA and Switzerland.

The entitlement to the exemption depends on certain conditions, such as specific shareholding (at least 15% from 1 January 2007 and 10% from 1 January 2009; in the case of dividends received from Switzerland the minimum shareholding amounts to 25%). The Polish company must be the shareholder of the company paying the dividend for at least two years. If these conditions are not met by the recipient, the double taxation will be eliminated in accordance with the existing rules, i.e. by offsetting the tax collected abroad with tax liabilities in Poland (the tax credit method).

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Portugal – Capital gains exemption regarding sale of owner-occupied dwellings to be amended

On 26 October 2006, the ECJ ruled that the Portuguese exemption from taxation of capital gains derived from the sale of an owner-occupied dwelling, subject to the condition that the sales proceeds of such dwelling are re-invested in the purchase of another owner-occupied dwelling located in the Portuguese territory, as foreseen in Article 10(5) of the Personal Income Tax Code, is discriminatory.

The State Budget for 2007 contains an authorisation for the Portuguese Government to amend the referred article by including under the exemption reinvestments made in owner-occupied dwellings located in another EU Member State or in the EEA.

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Sweden – Tax Board rulings on group contributions to foreign affiliates

New rulings from the Swedish Tax Board have confirmed the Marks & Spencer principles in respect of deduction for Swedish group contributions (i.e. the Swedish way of shifting income within qualifying domestic groups) to foreign affiliates. In one of these recent cases, however, the Swedish deduction for a contribution to a Norwegian sister company with losses was refused on the grounds that the right to cross-border loss utilisation does not go beyond the ECJ's Mark & Spencer principles, i.e. from a foreign subsidiary to a domestic parent.

A few other cases have dealt with similar situations but with for instance non-EU parents involved, which cases were dismissed by the Swedish Tax Board because it held that the cases concerned the freedom of establishment, which does not extend to third countries.

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UK – Court of Appeal judgement concerning cross border loss relief

The UK Court of Appeal handed down its judgement in the case of Marks & Spencer plc v David Halsey (HM Inspector of Taxes), concerning cross border loss relief, on 20 February 2007, broadly upholding the previous High Court decision.

Marks & Spencer plc (M&S) had claimed group relief for losses of its French, German and Belgian subsidiaries. The case was referred to the ECJ for a preliminary ruling and the ECJ issued its judgement on 13 December 2005. In overview, the ECJ held that the UK group relief rules, which do not allow for the surrender of losses by non-UK resident companies, were contrary to Articles 43 and 48 (freedom of establishment) of the EC Treaty, but that the restriction could be justified, except in situations where the non-resident subsidiary has exhausted the possibility available to it in its state of residence for the losses to be taken into account in current, past and future periods.

The case was referred back to the UK High Court to implement the ECJ judgment. In April 2006 the High Court decided two key issues:

What is meant by a company having exhausted all possibilities of utilising the loss in its home territory? The High Court held that the reference to "possibilities" of using the losses in the ECJ judgment should be interpreted as meaning "recognised possibilities legally available given the objective facts of the company's situation at the relevant time".

When must the claimants show that all possibilities of utilising the losses have been exhausted? The High Court held that the "relevant time" should be the time when the group relief claim is made and not, as HMRC had contended, the end of the period in which the losses arose. M&S's appeal in relation to the losses of its French subsidiary was dismissed on the basis that those losses had already been utilised in France, but the appeal in relation to the losses of its German and Belgian subsidiaries was remitted back to the UK Special Commissioners to determine whether all possibilities of using their losses had been exhausted in the light of the High Court judgment.

The Court of Appeal has now held as follows:

It broadly agreed with the High Court judgement concerning the issue of whether there is any possibility of utilising the losses in the loss company's home territory, but accepted that some of the comments, particularly those concerning the possibility of utilising losses in future periods, may be subject to misinterpretation. It will now be for the Special Commissioners to decide whether all possibilities of utilising the German and Belgian losses have been exhausted.

It upheld the High Court decision that the relevant date for determining whether the possibilities of utilising the losses have been exhausted, is the time at which the group relief claim is made.

It accepted that, following the EU law principle of effectiveness, the period during which companies should be permitted to make claims for group relief should be extended to allow claims to be made within a reasonable transitional period after the ECJ judgment. This may allow companies which have not already done so to make new or additional claims for cross border loss relief, even though domestic time limits have been exceeded.

As a fall back position, M&S argued that the ECJ judgment should be interpreted as meaning that the requirement in the group relief for the surrendering company to be UK resident should be automatically disapplied in all cases. The Court did not support the view in this case and declined to make a further reference to the ECJ on this point, although noted that the matter is the subject of an appeal in another case (Fleming).

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EU DEVELOPMENTS

European Commission proposes new EU guidelines to avoid transfer pricing disputes

On 26 February 2007, the European Commission announced that it had adopted new EU-wide Guidelines on Advance Pricing Agreements (APAs) aimed at avoiding transfer pricing disputes and increasing legal certainty for companies. Resolving international tax disputes has become a major issue for businesses and tax administrations in Europe and they have increased both in number and complexity, and this trend is expected to continue. An APA is an agreement between a tax administration and a taxpayer on how future transactions between associated companies established in two or more EU Member States will be taxed.

By promoting the use of APAs, the Commission wants to avoid costly and time-consuming tax examinations into the transactions included in the APA, relieve the large administrative burden on taxpayers and eliminate double taxation. Typically, double taxation happens when there is a dispute between taxpayers and tax administrations over what amount of profit should be taxed followed by a dispute between the tax administrations over where the tax should be paid.

The new APA Guidelines are based on the best practice identified by the EU Joint Transfer Pricing Forum (EUJTPF). They explain how EU Member States should conduct the APA process, provide guidance to the taxpayers and describe how some specific problems could be resolved. The Guidelines on APAs are part of a wider effort by the Commission to promote a more streamlined EU-wide approach to transfer pricing based on the work of the EIJTPF, which brings together experts from national tax administrations and business representatives. The EUJTPF advises the Commission and is widely regarded as a useful political forum, although the OECD remains the main forum for transfer pricing issues in Europe.

The Commission has asked the Council to endorse the proposed Guidelines on APAs in the EU and called on Member States to implement the recommendations in their national legislation or administrative rules. To view the proposed Guidelines, click here.

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European Commission publishes annual report on EU tax activities in 2006

On 31 January 2007, the European Commission published its (comprehensive) annual report on the activities of the European Union and the progress made in the tax field in 2006. Click here to view the report.

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European Commission decides whether energy tax breaks in Germany, France, Ireland and Italy constitute infringements of State aid rules

Taxation of energy products used as fuel has been harmonised by the Energy Tax Directive 2003/96/EC, applicable as of 1 January 2004. The Directive does not cover non-fuel or dual-use cases. In Germany, non-fuel uses of energy products are generally exempt form energy tax. This exemption extends to dual-use situations, as e.g. in steel production, where the energy products are also used as raw materials. In France, Ireland and Italy, mineral oils used as fuel for alumina production (considered a dual-use case falling outside the scope of the Directive) are fully exempt from excise duty.

On 8 February 2007 the European Commission decided that.

The German exemption for dual-use energy products does not constitute state aid because it: follows the logic of the tax system and is consistent with its overall objectives; and applies consistently to all dual-use cases

In the cases of France, Ireland and Italy, however, only 80% of the exemptions as from 1 January 2004 are compatible with EU State aid rules. Under the Guidelines on State aid for environmental protection, full tax exemptions are only compatible if they are based on binding agreements between the Member State and the recipient firms achieving environmental protection objectives. Such agreements have, however, not been concluded and the exemptions are highly selective as, in practice, they benefit only one company per country or one sector. Therefore, the Commission ordered France, Ireland and Italy to recover 20% of the tax exemptions granted as from 1 January 2004 and to suspend any payments of the compatible aid to the beneficiaries until they have paid back the incompatible aid.

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Belgium – European Commission requests Belgium to terminate discriminatory taxation concerning houses outside Belgium

On 8 January 2007, the European Commission announced that it had sent Belgium a Reasoned Opinion under Article 226 of the EC Treaty to end its discriminatory taxation of houses located outside Belgium. Belgium needs to reply to the Commission in a satisfactory way otherwise the Commission may refer the matter to the ECJ.

Under Belgian law a distinction is made between owner-occupied houses (dwellings) and secondary houses. The Belgian Income Tax Code (Arts. 104, 115 and 145/17) provides for a limited deduction of mortgage interest and for a deduction of capital repayment of a mortgage loan and contributions paid on a life insurance contract related to a mortgage loan. With respect to secondary houses, a tax relief is available for the payment of mortgage loans (Art. 145/1(3)). In both cases the relief is only granted for houses situated in Belgium.

The Commission considers that the limitation of tax relief for secondary houses to houses in Belgium restricts the free movement of capital as guaranteed by Article 56 of the EC Treaty, as it dissuades Belgian residents from buying a secondary house outside Belgium.

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Greece – European Commission sends Greece a formal request to end its discriminatory taxation of foreign partnerships

On 8 January 2007, the European Commission announced that it had sent Greece a formal request to end its discriminatory taxation of foreign partnerships. Greece has acknowledged this difference in the tax rates but reasons that it is justified as a proportion of the profits of a domestic partnership is taxed in the hands of the individual partners. On the contrary, the Commission points out that this difference does not necessarily entail higher taxation, but in some cases it may even result in a lower effective tax rate.

Under Greek tax legislation, partnerships which have their statutory or real seat in Greece are taxed at a lower rate than partnerships which have their statutory or real seat in another EU Member State. In particular, according to Greek tax legislation, Greek partnerships are subject to income tax in their name (i.e. they are not transparent). In particular, 50% of the profits of partnerships are taxed in the entity's name at the rate of 20% for the fiscal year 2007 onwards (for the fiscal years 2005 and 2006 the applicable tax rates were 24% and 22% respectively). In case where the partners are individuals, the remaining 50% of the profits is considered as the entrepreneur's fee and is deducted from the partnership's net profits for up to 3 individual partners possessing the greatest percentages of participation to the partnership. This fee is determined by multiplying the percentage of participation to the partnership with the 50% of the partnership's net profits, and is further taxed in the partner's name according to the income tax scale applicable to individuals. In case where all partners are legal entities the partnership's total profits are taxed in its name.

On the contrary, branches of foreign companies are subject to Greek corporate tax in a way similar to the one applicable to Greek corporations i.e. at the rate of 25% for the fiscal year 2007 onwards (for the fiscal years 2005 and 2006 the applicable tax rates were 32% and 29% respectively).

The reply that was possibly sent to the Commission has not been made public. In addition, no official announcement by the Greek Government has been made as in the case of the discriminatory inbound dividends taxation where the Ministry of Finance has announced that the amendment of the Greek tax legislation in order to be compatible with the EU law is under examination.

The Commission request is in the form of a Reasoned Opinion, which is the second stage of the infringement procedure under Art. 226 of the EC Treaty. If Greece does not reply satisfactorily to the reasoned opinion within 2 months, the Commission may refer the matter to the ECJ.

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Italy – European Commission requests Italy to abolish the withholding tax on dividends distributed to Dutch parent companies

On 9 January 2007, the European Commission sent Italy a formal request to end the application of the withholding tax on dividends distributed to Dutch parent companies. The Commission considers that the withholding tax levied, up to 31 December 1997, is not in conformity with the Parent-Subsidiary Directive (Directive 90/435/EEC) which, under certain conditions, provides for the exemption from any withholding tax concerning dividend distributions between companies resident in different Member States.

The Commission points out that the Italian Tax Authorities refuse the reimbursement of the 5% withholding tax on dividends provided for by the 1990 Italy-The Netherlands Income Tax Treaty following the principles established by the jurisprudence of the Italian Supreme Court (Corte di Cassazione) which refers to the previous tax credit system effective until 2003 (when Italy adopted the exemption regime for dividend distributions). The Commission also underlines that the Court gives a "too extensive" interpretation of the Parent-Sub Directive.

The Italian Supreme Court denied the right to the reimbursement of the 5% withholding tax relevant to the dividend on the basis of the application of the Tax Treaty which provides for the application of the mentioned withholding tax and the reimbursement of the so-called "maggiorazione di conguaglio" (i.e. an additional taxation applied until 31 December 1997, in the case of profits fully or partly untaxed, at the moment of the dividend distribution with the aim of securing that the dividend was taxed at a rate corresponding to the tax credit received by the shareholders).

The Court said that the 5% withholding tax on dividend was in line with the Parent-Sub Directive, according to Article 7.2 of the same Directive which might permit the application of a treaty withholding tax when its aim is to reduce the dividend double-taxation. The Court, against whose decisions there is no judicial remedy under Italian law, also refused to bring the matter before the ECJ citing that the issue had already been judged in the *Océ van der Grinten NV* case (C-58/01).

The Commission's request is in the form of a Reasoned Opinion under Article 226 EC. Italy must reply in a satisfactory way to the request within 2 months, or else the Commission may refer the case to the ECJ.

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Italy and Spain – European Commission closes infringement proceedings against Italy and Spain

The European Commission has closed the case against Spain over its tax rules relating to pension contributions paid to non-Spanish funds. The Commission has also closed a case against Italy that was opened with regard to its way of notifying fiscal acts to non-resident persons.

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Netherlands – European Commission opens a formal investigation procedure for one part of the proposed Dutch patent box ('groepsrentebox')

On 7 February 2007, the European Commission decided to open a formal investigation procedure to examine if the proposed Dutch patent box ('groepsrentebox') violates EU State aid rules.

Amongst other amendments to the Corporate Income Tax Act, the Dutch Government proposed a tax break scheme called the 'groepsrentebox'. This box aims at reducing the different fiscal treatment of debt and equity as instruments of intra-group financing. A different treatment of intra-group financing occurs since the payment of interest leads to a deductible expense and a taxable receipt while a dividend distribution is neither deductible upon distribution nor taxable upon receipt.

Optional application of the 'groepsrentebox' leads to deduction and taxation of intercompany interest income at an effective tax rate of 5%. Income arising from short-term investments earmarked for financing future acquisitions can also be included in the 'groepsrentebox'.

Even though the Ministry of Finance takes the view that the legislation at issue does not violate EC Treaty State aid rules, it has nevertheless been reported to the Commission.

Article 87 of the EC Treaty provides that legislation constitutes State aid if:

- the legislation assigns to the recipients an advantage which relieves them of charges that are normally borne from their budgets;
- the advantage is granted by the State or through State resources;
- the legislation affects competition and trade between Member States; and
- the legislation is selective or specific in that it favours certain undertakings or the production of certain goods.

Although the tax break scheme is open to all companies, the Commission takes the view that *de facto* only groups of companies may benefit from this scheme. Furthermore, the scheme is likely to attract only multinational groups of companies as it appears to be neutral for Dutch groups since the interest payments are both deducted and taxed at the lower rate domestically. Consequently, the Commission considers the scheme in this stage as a selective advantage to certain companies which needs to be examined as a possible violation of EC Treaty State aid rules.

In addition to this general rule, the tax break scheme also applies to interest income arising from short-term investments held for the purpose of financing future acquisitions. With regard to this amendment, the Commission takes the view that it applies *de facto* to all companies, including those who are not part of a group. According to the Commission, this amendment does not constitute a selective advantage to certain companies and therefore does not result in a violation of EC Treaty State aid rules. See also EUDTG Newsalert NA 2007 – 003.

-- Frauke Davits and Frank Engelen, The Netherlands;

Portugal – European Commission requests Portugal to end discriminatory taxation against foreign service providers

On 8 January 2007, the European Commission has sent a formal request to Portugal to amend its tax legislation concerning taxation of services rendered in Portugal by non-resident entities. According to the law in force, non-resident service providers are subject to a final withholding tax applicable to the gross amount of their income, whereas domestic providers will be taxed only on their net profits, i.e. after deduction of related costs. The Commission considers that the difference of treatment applicable to income received by resident and non-resident services providers in Portugal constitutes an infringement to the freedom to provide services foreseen in article 49 of the EC Treaty, as this difference of treatment may dissuade foreign service providers from providing services in Portugal, and dissuade Portuguese clients from buying services from foreign providers. Additionally, the Commission understands that this measure is disproportionate to the aim claimed by Portugal of preventing fraud. 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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Switzerland – European Commission adopts formal decision on Swiss company tax regimes

In a decision of 13 February 2007, the European Commission took the formal position that certain company tax regimes in Swiss Cantons in favour of holding, mixed and auxiliary (management) companies are a form of State aid incompatible with Article 23(1) of the 1972 Free Trade Agreement between Switzerland and the EU.

Under Swiss law, the Cantons may fully or partially exempt profits generated abroad from cantonal and municipal company tax. All Swiss Cantons have made use of this provision, although in different forms. According to the Commission, this has proved to be a formidable incentive for the headquarters, co-ordination and distribution centres of multinationals to be based in Cantons such as Zug and Schwyz, in order to minimise their tax liabilities. As these multinationals are mostly active in the EU, such tax regimes may directly or indirectly affect trade between the EU and Switzerland, the Commission said. The Commission said that while it is not against tax competition or low tax rates, it cannot accept schemes that differentiate between domestic and foreign source income. It therefore demands from Switzerland that it abolishes or amends these schemes.

However, the Swiss Federal Government has entirely rebutted the Commission's challenges based on the following main arguments:

- There is no contractual obligation between Switzerland and the EU based on which Switzerland must align its company taxation system with that of the EU Member States. The Free Trade Agreement does not provide a sufficient basis to judge company tax matters, in particular concerning distortion of competition. Moreover, at the time of signature of this Agreement, these cantonal tax regimes were already in existence, and have “co-existed" with this Agreement for over than 30 years now.
- Switzerland is not part of the EU and the Internal Market, as such neither the EU's State aid rules of the EC Treaty nor the EU's Code of Conduct on Business Taxation apply to Switzerland
- The challenged regimes do not have an impact on the trade between the EU and Switzerland, since under no such company regimes are any trading activities permissible in the Swiss market - with the exception of the mixed company regime whereby a limited activity in Switzerland is allowed. In such case though, the resulting "Swiss" income is ordinarily taxed without any relief. Further, these regimes are available to all groups with international activities, regardless of nationality or economic sector.

The changes in the tax law that the Commission demands from Switzerland would require a majority vote from the Swiss cantons or a referendum by the Swiss people.

Meanwhile, the Commission will try to obtain a formal mandate from the Member States for negotiations with Switzerland on this matter in the coming months, although Switzerland has already said that there is nothing to negotiate about.

The Commission also stated in the Decision that it reserves the right to propose the adoption of safeguard measures to the Council in accordance with Article 27(3)(a) of the Free Trade Agreement. Such measures could – among others – include the introduction of customs duties for companies benefiting from the Swiss aid in order to remedy the alleged distortion of competition and the effect on trade.

Member States disagree as to whether qualified majority is required for the eventual adoption of EU safeguard measures in the Council, or a unanimity, as the safeguard measures in this particular case may be fiscal measures. No definitive answer can yet be given to this at this stage

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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 A-Gainst 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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