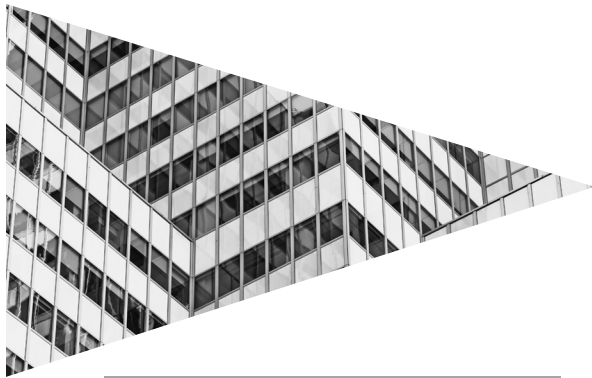


EU direct tax news

A bimonthly review of EU direct tax developments
affecting business in Europe



Editorial

Dear Reader,

Taxation of individuals and corporations is still high on the agenda of European governments and the Court of Justice (CJ). Also, it was given particular focus in a recent case at the European Court of Human Rights (ECtHR). The ECtHR rendered an important judgment on the role of human rights in the field of corporate taxation in the *Yukos* case. This case is highlighted in our "Focus on" article. Euro Member States are currently struggling to find the final mechanism to stabilize the euro system. To support this endeavor, the European Commission (EC) has recently published a taxation paper describing, in detail, the potential instruments in taxation to raise revenue, while at the same time promoting growth and not distorting competition. The key findings of this report can be found in our "Major developments" section.

Dr. Klaus von Brocke

Major developments

Euro stability measures in the field of taxation

In October 2011, the EC published an important taxation paper, entitled *Tax Reforms in EU Member States 2011*.¹ As well as examining and comparing Member States' recent measures and developments in the area of taxation, the paper describes potential steps and means to improve and increase the revenue side of public finances. Some of the key findings of this report, as well as the EU policies in which most of the activities are embedded, are described below.

In addition to public expenditure control, EU Member States attach increasing importance to taxation measures in order to balance their public finances after the major impact of the financial and economic crisis. The use of taxation measures to counter the effects of the financial and economic crisis has led to an increase in the proportion of tax revenues in relation to GDP, after a considerable decline in the years 2008 and 2009.

Thus, the tasks of a functioning tax system consist of consolidating public finances, reducing tax distortions, correcting market failures (where necessary), avoiding tax inconsistencies regarding cross-border transactions and, most importantly, supporting a sustainable growth. This last point could be achieved, in general, by shifting the tax burden from direct taxes toward indirect taxes. Simulations and empirical evidence have proved that indirect taxes have the least negative effect on economic growth. Other suggestions on how to support growth in tax revenues include reducing tax expenditure and closing other loopholes in corporate taxation, increasing consumption taxes and correcting the undesired effects of the consumption of certain goods by raising environmental, tobacco and alcohol taxes. These suggestions are described below, although the microeconomic effects resulting from the increase of selected types of taxes need further and more detailed analysis.

Different tax measures have the potential to foster economic growth in EU Member States.

- a) Lowering direct taxes such as labor tax, individual and corporate income tax and social security contributions, while increasing consumption taxes and recurrent real estate tax, will result in higher employment and labor utilization because of higher incentives for both workers and employers. An increase in indirect taxes, by contrast, does not lead to any accumulation of specific production factors supporting economic growth. By shifting the tax burden away from labor tax, low income earners would be relieved, thus, fostering social equity.

¹ See http://ec.europa.eu/economy_finance/publications/european_economy/2011/pdf/ee-2011-5_en.pdf.

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About one-third of the Member States, i.e., the states with very high revenues from labor tax, but low revenues from indirect taxes, should bear in mind that lower labor taxes result in higher net wages, which might lead to an increase in the inflation rate.

- b) Increasing environmental taxes and consumption taxes on tobacco and alcohol may help to cope with the undesired effects of the consumption of certain goods such as pollution and high expenditures for health care. Furthermore, a detailed review of subsidies is necessary to reveal subventions for polluting or carbon-intensive activities.
- c) Increasing housing taxes might be another option to take away the tax burden from income. Alternatively, the real estate transaction tax could be shifted toward a recurrent tax on immovable property.
- d) Instead of solely increasing different taxes, the efficiency of tax collection and prevention of tax evasion has to be improved. One-third of the Member States is currently challenged with shadow economies and tax evasion.

Also, the debt bias - which may lead to a credit crunch in bad times, and to a credit growth in good times - can be solved with tax measures. Accordingly, the interest deductibility for tax purposes should be abolished through a comprehensive business income tax (CBIT), or an equivalent allowance for corporate equity should be introduced. Under a CBIT regime, interest and dividends would be neither deductible by corporations nor taxable to investors. The same regime would apply to non-corporate business entities; so that all business income would be taxed at the same flat rate. A combination of both approaches could be conceivable, too.

On the level of international cooperation between EU Member States, some projects have been implemented as set out below:

- a) The European semester, including the Annual Growth Survey (AGS)

The tax system has to support economic growth. This approach is dealt with in the annual assessment of each Member State's broad policy strategy, called the European semester.

It is supported by studies of the AGS, which stress the tax shift from direct toward indirect taxation in order to encourage the demand for labor and create jobs.

- b) Macroeconomic analysis by the Economic and Financial Affairs (ECOFIN) Council

The Economic Policy Committee (EPC) and the Alternates of the Economic and Financial Committee (AEFC) analyzed the bottlenecks to growth, of which only a few were identified in the area of taxes. These few refer mainly to tax policy issues regarding labor taxation already mentioned above.

- c) Euro Plus Pact

The Euro Plus Pact works on measures to achieve a more successful economic policy and improve competitiveness, focusing mainly on topics that fall under national competence. States joining the Pact are committed to pursuing the following objectives: foster competitiveness and employment, contribute to sustainability of public finances and reinforce financial stability.

These targets shall be accomplished through tax coordination and the exchange of best practice between the Member States. A common corporate tax base is also being discussed.

- d) The assessment of national reform strategies by the Commission and the Council

The results of the European semester are reviewed by the Commission and the Council. The national policy strategy of every Member State elaborated during the European semester or in the Euro Plus Pact is stated in its Stability and Convergence Programmes (SCPs) and in its National Reform Programmes (NRPs).

Focus on

The Decision of ECtHR in the *Yukos* case

Robert Attard/Tax Policy Leader/CSE

On 20 September 2011, the ECtHR delivered its long-awaited Chamber decision² in the case brought forward by the Russian company *OAO Neftyanaya Kompaniya Yukos (Yukos)* against Russia (14902/04). Should the Grand Chamber confirm the Chamber judgment, the *Yukos* case will become the leading case on taxation and human rights.³ It stands out for a number of reasons: the sums involved are astronomical, with tax charges running into billions of euros; the *Yukos* case involved a large Russian oil company which has, since the filing of the proceedings, ceased to exist; furthermore, the *Yukos* case received advance media publicity, was a politically sensitive case and has made businesses more aware of their human rights.

The following are the salient facts of the case:

1. In 2002, *Yukos* became the subject of a series of tax investigations and, eventually, was found guilty of repeated tax fraud involving the use of letter-box companies.
2. In April 2004, pending the outcome of the case, assets of *Yukos* were seized in enforcement proceedings.
3. In May 2004, *Yukos* was ordered to pay €2.847b as taxes, interest and penalties for infringements committed in 2000.
4. In 2004, proceedings were extended to cover infringements occurring in 2001 and 2002.
5. *Yukos* appealed the decision that ordered it to pay taxes, interest and penalties but, in June 2004, it lost its appeal.
6. In July 2004, *Yukos* filed another appeal to the Court of Cassation, claiming

² Application no. 14902/04.

³ The Chamber judgment is not a final judgment. The parties to the case have the right to refer the case to the Grand Chamber within three months. Decisions of the Grand Chamber are final and will become binding on the Russian state.

that the case against it had been time-barred, but it lost this appeal, too.

7. *Yukos* was ordered to pay over €8,000m as taxes, interest and penalties for years 2001 and 2002, on top of which it was ordered to pay a bailiff's enforcement fee of 7% of the total debt.
8. *Yukos* was ordered to effect all payments within a very short time, and requests to delay enforcement were denied.
9. In December 2004, *Yukos's* assets were auctioned and, in 2006, *Yukos* was declared insolvent.
10. In 2007, *Yukos* was liquidated.

The *Yukos* case took several years to decide, with both parties filing extremely lengthy submissions and arguments. *Yukos* complained of violation of its fundamental human rights, including its right to property and its right to a fair hearing. The tax proceedings had resulted in the financial ruin of *Yukos*.

In January 2009, the ECtHR declared *Yukos's* claim admissible and, in the wake of recent decisions such as its 2008 decision in *Kallio*, held that Article 6 of the European Convention on Human Rights (ECHR), which gives right to fair trial,⁴ applied to Russia's 2000 tax assessment "under its criminal head." On 20 September 2011, the ECtHR found that Russia had violated some of *Yukos's* rights, some of which are highlighted below.

Yukos alleged violations of Article 1 of Protocol No. 1 taken alone (the right to property), as well as in conjunction with Articles 1, 7, 13, 14 and 18 ECHR.⁵

⁴ The ECtHR decided that cases involving tax surcharges that are deterrent and punitive are, unlike pure tax cases that were ruled not to amount to determinations over civil rights and obligations, covered by the right to a fair hearing.

⁵ Namely, protection from discrimination and double jeopardy and right to an effective remedy.

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Focus on

The Decision of ECtHR in the *Yukos* case

Yukos complained that the 2000–2003 tax assessments were imposed and enforced in a disproportionate and unlawful manner.

The allegation that the tax assessment 2000–2003 had not been based on a reasonable and foreseeable interpretation of domestic law

The ECtHR proceeded to examine the allegation that the tax assessment 2000–2003 had not been based on a reasonable and foreseeable interpretation of domestic law. The ECtHR observed that it is not its task to take the place of domestic courts. It referred to the merits of the case and discussed some typical issues in international tax law. For the first time, the ECtHR discussed, in detail, issues relating to transfer pricing and the use of letter-box companies.

“591. From the findings of the domestic courts and the parties’ explanations, the Court notes that the company’s ‘tax optimization techniques,’ applied with slight variations throughout 2000–2003, consisted of switching the tax burden from the applicant company and its production and service units to letter-box companies in domestic tax havens in Russia. These companies, with no assets, employees or operations of their own, were nominally owned and managed by third parties, although, in reality, they were set up and run by the applicant company itself. In essence, the applicant company’s oil-producing subsidiaries sold the extracted oil to the letter-box companies at a fraction of the market price. The letter-box companies, acting in cascade, then sold the oil either abroad, this time at market price, or to the applicant company’s refineries and, subsequently, re-bought it at a reduced price and re-sold it at the market price. Thus, the letter-box companies accumulated most of the applicant company’s profits. Since they were registered in domestic low-tax areas, they enabled the applicant company to pay substantially lower taxes

in respect of these profits. Subsequently, the letter-box companies transferred the accumulated profits unilaterally to the applicant company as gifts. The Court observes that substantial tax reductions were only possible through the mixed use and simultaneous application of at least two different techniques. The applicant company used the method of transfer pricing, which consisted of selling the goods from its production division to its marketing companies at intentionally lowered prices, and the use of sham entities, registered in the domestic regions with low taxation levels and nominally owned and run by third persons.” (see paragraphs 14–18, 48, 62–63 for a more detailed description).

“592. The domestic courts found that such an arrangement was, at face value, clearly unlawful domestically, as it involved the fraudulent registration of trading entities by the applicant company in the name of third persons, and its corresponding failure to declare to the tax authorities its true relation to these companies (see paragraphs 311, 349–353, 374–380). This being so, the Court cannot accept the applicant company’s argument that the letter-box entities had been entitled to the tax exemptions in question. For the same reason, the Court dismisses the applicant company’s argument that all the constituent members of the *Yukos* group had made regular tax declarations and had applied regularly for tax refunds, and that the authorities were, thus, aware of the functioning of the arrangement. The tax authorities may have had access to scattered pieces of information about the functioning of separate parts of the arrangement, located across the country, but, given the scale and fraudulent character of the arrangement, they certainly could not have been aware of the arrangement in its entirety, on the sole basis of the tax declarations and requests for tax refunds made by the trading companies, the applicant company and its subsidiaries.”

Focus on

The Decision of ECtHR in the *Yukos* case

The ECtHR found nothing wrong in the anti-abuse measures directed against tax avoidance schemes. On this ground, the ECtHR decided in favor of Russia, concluding that Russia's anti-avoidance rules contained a sufficiently clear legal basis:

"593. The arrangement was obviously aimed at evading the general requirements of the Tax Code, which expected taxpayers to trade at market prices (see paragraphs 395-399), and by its nature involved certain operations, such as unilateral gifts between the trading companies and the applicant company through its subsidiaries, which were incompatible with the rules governing the relations between independent legal entities (see paragraph 376). In this connection, the Court finds relevant the warning, given by the company's auditor, about the implications of the use of the company's special fund during the year 2002 (see paragraphs 206-209), and is not persuaded by the applicant company's reference to case no. A42-6604/00-15-818/01 (see paragraphs 356-357), the expert opinion of its counsel (see paragraph 577) and its reliance on Article 251 (1) 11 of the Tax Code (see paragraph 376)."

"594. Thus, the Court cannot agree with the applicant company's allegation that its particular way of 'optimizing tax' had been previously examined by the domestic courts and upheld as valid, or that it had used lawful 'tax optimization techniques' that were only subsequently condemned by the domestic courts. The above considerations are sufficient for the Court to conclude that the findings of the domestic courts, that the applicant company's tax arrangements were unlawful at the time when the company had used them, were neither arbitrary nor manifestly unreasonable."

"595. The Court will now turn to the question whether the legal basis for finding the applicant company liable was sufficiently accessible, precise

and foreseeable. In this connection, the Court notes that, in all the tax assessments (see paragraphs 14-18, 48, 62-63, 165, 191-193, 212 and 213), the domestic courts essentially reasoned as follows. The courts established that the trading companies had been a sham and entirely controlled by the applicant company and, accordingly, reclassified the transactions conducted by the sham entities as transactions conducted, in reality, by the applicant company."

The complaint that the tax assessments for 2000-2003 did not pursue a legitimate aim and were disproportionate

The ECtHR declared that it was satisfied that, subject to its findings in respect of the lawfulness of fines for the years 2000 and 2001 made earlier, each of the tax assessments for 2000-2003 pursued a legitimate aim of securing the payment of taxes and constituted a proportionate measure in pursuance of this aim. The ECtHR found that the tax rates, as such, were not particularly high and, given the gravity of the tax fraud, there was nothing to suggest that the rates of the fines or interest payments should be viewed as having imposed an individual and disproportionate burden, as such, on *Yukos*.

Complaints relating to the enforcement of the debt

The ECtHR held that the manner in which Russia enforced the debt resulting from the 2000-2003 tax assessment proceedings violated *Yukos's* right to property. According to the ECtHR, the 7% enforcement fee was, by its very nature, unrelated to litigation costs. The ECtHR observed that there is nothing wrong, as a matter of principle, with requiring a debtor to pay for the expenses relating to the enforcement of a debt, or to threaten a debtor with a sanction to incite their voluntary compliance with enforcement writs but, in the circumstances of the case, the resulting sum was completely out of proportion to the amount of the enforcement expenses that could have possibly been expected to be borne, or had actually been borne, by the bailiffs.

Focus on

The Decision of ECtHR in the *Yukos* case

Because of its rigid application, instead of inciting voluntary compliance, it contributed very seriously to the applicant company's demise. The Court concluded that:

"Lastly, the Court would again emphasize that the authorities were unyieldingly inflexible as to the pace of the enforcement proceedings, acting very swiftly and constantly refusing to concede to the applicant company's demands for additional time. Nevertheless, the Court finds that, in the circumstances of the case, such lack of flexibility had a negative overall effect on the conduct of the enforcement proceedings against the applicant company."

"On the whole, given the pace of the enforcement proceedings, the obligation to pay the full enforcement fee and the authorities' failure to take proper account of the consequences of their actions, the Court finds that the domestic authorities failed to strike a fair balance between the legitimate aims sought and the measures employed."

"To sum up, the Court concludes that there has been a violation of the applicant company's rights under Article 1 of Protocol No. 1, on account of the State's failure to strike a fair balance between the aims sought and the measures employed in the enforcement proceedings against the applicant company."

The relevance of the *Yukos* case

To those who, over the last five years, have been following the tax cases of the

ECtHR, its conclusions might have appeared to be somewhat predictable. Had the *Yukos* case involved a smaller company, low-profile individuals, another state and especially not all those billions, it would have passed virtually unnoticed. However, it can be clearly stated that the ECtHR is becoming more active in matters relating to taxation, especially with regard to tax laws with criminal law features.

Recent cases involving countries such as Finland,⁶ the Ukraine,⁷ Bulgaria⁸ and Italy⁹ established principles that are much more groundbreaking than those confirmed in *Yukos*. It barely sets a precedent, but one cannot be dismissive of its effects. From a jurisprudential standpoint, the *Yukos* case adds very little, but it will have a profound impact on tax controversy. It was sensational and placed the ECtHR on the map of tax dispute resolution. The case created a great deal of awareness and a fertile ground for future challenges. The 163-page judgment on *Yukos* provides the uninitiated cases with a compendium of the role the ECtHR has to play in tax matters.

⁶ *Ruotsalainen vs. Finland*, application no. 13079/03.

⁷ *Shchokin vs. Ukraine*, applications nos. 23759/03 and 37943/06.

⁸ *Bulves AD vs. Bulgaria*, application no. 3991/03.

⁹ *Di Belmonte vs. Italy*, application no. 72638/01.

Direct tax

Country updates

Belgium

1. Withholding tax (WHT) on outbound (deemed) dividends - request for preliminary ruling

In a decision on 27 June 2011, the Brussels Court on First Instance requested a preliminary ruling from the CJ regarding the Belgian WHT regime (C-384/11, *Tate & Lyle Investments Ltd vs. Belgische staat*).

The facts of the case can be summarized as follows: a UK company holds a 5% shareholding with a historic acquisition value of over €1.2m in a Belgian company. Upon partial demerger of the Belgian subsidiary, the dividend that is deemed to be distributed to the UK parent company is taxed at 10% since the domestic WHT exemption cannot be applied (a 10% shareholding is required under Art. 106 Royal Decree implementing the Belgian Tax Code). As the WHT is not refundable under Belgian domestic tax law, this WHT constitutes a final tax for the UK parent company.

However, if the parent company had been a resident company, the same WHT of 10% would have been deductible from the corporate income tax payable in Belgium and the balance, if any, would have been refundable (Art. 279 et seq. Income Tax Code (ITC)). Moreover, such a company could be entitled to the application of the Belgian Dividends Received Deduction (DRD) regime (at the material time, the DRD regime required a shareholding of at least 10% or having a purchase value of at least €1.2m), which would allow for the tax base to be reduced further by the costs relating to the shareholding.

The Brussels Court of First Instance requested the CJ to rule on whether this legislation is compatible with the free movement of capital (Article 63 Treaty on the Functioning of the European Union (TFEU); previously Article 56 EC Treaty). In the light of a recent judgment in Case C-284/09 *Commission vs. Germany* (a similar case regarding German WHT on dividends) it is very likely that the CJ will consider that the Belgian tax rules restrict the free movement of capital.

2. Notional interest deduction - request for preliminary ruling

In a decision on 24 June 2011, the Antwerp Court of First Instance requested

a preliminary ruling from the CJ with regard to the Belgian notional interest deduction (C-350/11, *Argenta Spaarbank NV vs. Belgische Staat*).

The taxpayer is a Belgian resident company with a permanent establishment in the Netherlands. The profits realized through this permanent establishment are exempt in Belgium under the Belgium - Netherlands tax treaty.

Article 205ter (2) ITC provides that in cases where the income of a foreign PE is exempt in Belgium under a double taxation treaty, the Belgian resident company cannot apply the notional interest deduction in the amount of the positive difference between (i) the net book value of the assets attributable to permanent establishments and (ii) the total liabilities that are attributable to those establishments. However, such limitation does not apply with respect to the positive difference that can be attributed to a permanent establishment located in Belgium.

The Court of First Instance requests the CJ to rule on whether or not this rule is compatible with the freedom of establishment (Article 43 EC Treaty; now Article 49 TFEU).

3. Belgian Constitutional Court rules that Article 10, §1 and Article 11, §2, (c) of the double tax treaty between France and Belgium are not discriminatory

On 30 June 2011, the Belgian Constitutional Court (*Grondwettelijk Hof/Cour constitutionnelle*) ruled that Articles 10 (1) and 11 (2) (c) of the France - Belgium tax treaty are compatible with the non-discrimination principles guaranteed by Articles 10 and 11 of the Belgian Constitution and the prohibition of the granting of privileges as set forth in Article 172 of the Belgian Constitution (Case No 117/2011, *Xavière Minet vs. Belgium*).

Background

Mrs. Xavière Minet, a Belgian citizen resident in France, was employed in the border district of Belgium as a civil servant working on a contractual basis for a Belgian public entity.

Belgium

The Belgian tax administration is of the opinion that, under Article 10 (1) of the France - Belgium tax treaty, Belgium has the right to tax the remuneration received by Mrs. Minet. Under that provision, remuneration paid by a public entity of a contracting state is exclusively taxable in that state, i.e., in this case, Belgium.

Mrs. Minet, however, argued that her remuneration is exclusively taxable in France, as under Article 11 (2) (c) of the France - Belgium treaty, the remuneration of residents of a contracting state who take up their employment in the border district of the other contracting state is exclusively taxable in their state of residence.

The question referred to the Court

The Court had to rule whether or not Articles 10 (1) and 11 (2) (c) of the France - Belgium treaty are compatible with the principles of equality and nondiscrimination contained in Articles 10 and 11 of the Belgian Constitution to the extent that they (i) make an unjustified distinction in treatment between frontier workers employed on a contractual basis for a public or private employer and (ii) without reasonable justification, implement an equal treatment of frontier workers employed by a public entity, irrespective of whether they are employed on a contractual basis or statutory basis. In particular, workers employed on a contractual basis for a public employer are taxed in the state of the public entity, whereas workers employed on a contractual basis for a private employer are taxed in the state of residence of the employee.

Decision

The Court held that, the consequences of the differences in treatment are not unreasonable as it is not established that the choice of the paying state as the state competent to tax the remuneration can of itself be to the disadvantage of the taxpayer concerned. With reference to the decision of the CJ of 12 May 1998 in the Case *Gilly* (C-336/96), the Court concludes that, whether the tax treatment of the taxpayer concerned is favorable or unfavorable is determined not, strictly speaking, by the choice of the connecting factor but by the level of taxation in the competent state.

4. Payments to foreign service providers – Opinion of the Advocate General (AG)

On 29 September 2011, the conclusions of AG Villalón in the case *SIAT SA vs. Belgium* (C-318/10) were published. A preliminary ruling was made to the CJ by the Belgian Supreme Court on 2 July 2010, regarding the deductibility regime of direct or indirect payments for supplies or services by Belgian residents to foreign companies not subject to tax or subject to a tax regime, which is appreciably more advantageous (Art. 54 ITC).

In Belgian tax law, the deductibility of professional expenses is subject to the provisions of Article 49 ITC. According to this provision, expenses are tax-deductible if (i) they were incurred by the taxpayer during the taxable period in order to generate or maintain taxable income, and (ii) the reality and amount of such expenses can be justified by supporting documents.

Article 54 of the ITC, however, states that payments for supplies of services are not tax-deductible expenses where they are made or attributed directly or indirectly to a taxpayer resident in another country or to a foreign establishment if that taxpayer or establishment:

- ▶ Is not subject to a tax on income by virtue of the legislation of the other country; or
- ▶ Is subject, in respect of the relevant income, to a tax regime which is more advantageous than the Belgian tax regime that would be applicable to the same income.

The deductibility is nonetheless allowed if the taxpayer proves, by any legal means, that such payments relate to genuine and proper transactions and do not exceed the normal limits.

A taxpayer felt there was a discriminatory distinction between, on the one hand, payments to *tainted* service providers (in the case at hand, a Luxembourg "1929 holding company") falling under the more stringent deductibility conditions of Art. 54 ITC and, on the other hand, payments for the same supplies or services to *normally taxed* service providers falling under the conditions of Art. 49 ITC.

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Belgium

The AG concluded that there was a restriction of the freedom to provide services (Art. 49 EC Treaty, now Art. 56 TFEU). With reference to, among others, the CJ judgment in *Schwarz and Gootjes-Schwarz* (C-76/05), the AG considered that the freedom to provide services also precludes the application of any national rules that have the effect of making the provision of services between Member States more difficult than the provision of services purely within a Member State. The AG further considered whether or not this restriction could be justified by imperative requirements in the general interest. While the Belgian

legislation could potentially be justified by the need to prevent tax evasion and ensure the effectiveness of fiscal supervision, the AG opined that the legislation was disproportionate to the attainment of these objectives. In particular, the AG observed that the relevant provisions were too general, and were not targeted at, e.g., related-party service providers. A general presumption of tax evasion cannot be considered as a valid justification for a restriction on a fundamental freedom. The AG finally recommends that the article be declared incompatible with the freedom to provide services.

European Union

European Commission adopts proposals for a European Union-wide financial transaction tax (FTT)

On 28 September 2011, the EC published its proposals for the introduction of an EU-wide FTT. The FTT has proven to be a divisive topic, with France and Germany, the EU's biggest members, actively supporting it and playing a significant part in the drafting process, while the UK, home of the EU's biggest financial services center, has staunchly opposed it. It should also be noted that – alongside the UK – Belgium, Cyprus, France, Finland, Greece, Ireland, Italy, Romania and Poland all already have a form of FTT in place.

In a speech outlining the proposals, José Manuel Barroso, the EC President, said that the objectives of the FTT are threefold:

- ▶ To make the financial sector, which the EC considers is undertaxed, bear its fair share of the costs arising from the financial crisis
- ▶ To discourage certain “high risk” activities of the financial sector, such as high-frequency trading and highly leveraged derivatives
- ▶ To ensure coordinated action at EU level to avoid the fragmentation and distortion of the EU single market that would arise if individual Member States start to put in place national tax instruments in this area

The aim of the proposal is to tax a very wide base – approximately 85% – of transactions

carried out by financial institutions established in the EU that act as party to a transaction (wherever the transaction might take place), either for their own account or for the account of other persons. The concept of “financial institution” is given a wide definition and includes investment firms, organized markets, credit institutions, insurance companies, collective investment undertakings and their managers, alternative investment funds (such as hedge funds), financial leasing companies and special purpose entities. Taxation would take place in the Member States in which the establishments of the financial institution(s) involved in the transaction are established.

The FTT will apply to most types of financial instruments (securities, bonds, etc.) and derivatives (such as options), whether they take place on organized markets or as an over-the-counter trade. It would not, however, apply to activities on primary markets (i.e., the issuing of shares and bonds by companies and the public sector). Equally, it will not apply to everyday financial activities such as insurance contracts, mortgages, consumer and business credits or payment services, nor will it apply to transactions between financial institutions and the central banks of the Member States. Finally, in order to preserve the free movement of capital, currency transactions on spot markets will not be covered.

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European Union

The use of the residence principle – taxation in the Member State of establishment of the financial institution independent from the location of the transaction – clearly aims at avoiding the major criticism of an FTT, namely that it will lead to a relocation of activities. On the other hand, it gives rise to the risk of relocation of institutions and routing of transactions via non-EU established bodies.

The Commission has proposed that the minimum rates of tax that should be applied by Member States are 0.1% for bonds and shares and 0.01% for other kinds of transaction such as derivatives. At such levels, the tax could raise approximately €57b (approximately US\$77.6b) per year. Member States would be free to apply higher rates.

As noted by the EC, the tax would be paid immediately by financial institutions to Member States on the basis of the transactions undertaken, before netting and settlement. These are normally electronic transactions, in which case, the tax would be paid the same day it was due. If the transaction was not processed electronically, the FTT would be due within three working days, to allow the manual processing of transactions while avoiding unjustifiable cash flow advantages.

In addition, financial institutions that are liable to pay the FTT would have to submit a return to tax authorities. Member States

would be responsible for taking appropriate measures to prevent tax evasion. Such measures would likely include registration of financial institutions, accounting and reporting to ensure payment, collection and storage of relevant data on financial transactions at the disposal of tax authorities and verifying the correct payment of the tax.

The FTT proposal will now go to the Council of Ministers for consideration. Under the workings of the EC, such a proposal must receive unanimous support from all Member States. Given the previously expressed divergent views of Member States, it is difficult to see how the necessary unanimity can be obtained for the proposals to be adopted and to enter into force.

The Commission itself has only proposed that the draft Directive should be implemented from 1 January 2014. Nonetheless, it will be necessary for all interested parties to examine the full implication of the proposals carefully, since there is considerable support for them in at least some Member States.

On a wider level, the introduction of an FTT has been discussed on several occasions in the G20 in the last two years (Pittsburgh and Toronto). The current French Presidency of the G20 discussed the introduction of an FTT at global level at the G20 summit in Cannes on 3 and 4 November.

Finland

WHT on dividends paid to a Norwegian investment fund from Finland
On 30 March 2011, the Central Tax Board in Finland gave its ruling (KVL 21/2011) stating that WHT should not be levied on dividends paid from Finland to a Norwegian investment fund, because WHT is not levied on dividends paid to similar Finnish investment funds.

A Norwegian investment fund had applied for a preliminary ruling from the Finnish Central Tax Board as to whether it is a comparable entity to a Finnish investment fund and, consequently, not taxable in Finland and qualifying for an exemption for WHT in Finland.

The Norwegian investment fund was a separate legal entity, established according to the Norwegian legislation applicable to investment funds, and considered as an undertaking for collective investment in transferable securities (UCITS) within the meaning of the UCITS Directive (85/611/EEC). The Norwegian fund's assets were administered by a Norwegian joint stock investment company. The investment fund was a separate legal entity in Norway with unlimited tax liability for its income, although the dividends and capital gains received by the investment fund were mainly tax-exempt. The Norwegian investment fund was considered essentially similar to a Finnish investment fund.

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Finland

According to the ruling, as the Norwegian investment fund was considered as UCITS within the meaning of the Directive, no objective differences could be found when compared with a similar Finnish investment fund. The different tax treatment of the Norwegian and Finnish investment funds could not be justified on the basis of the coherence of the tax system or by the balanced allocation of taxing powers between Member States.

The provisions concerning the free movement of capital in the TFEU and the Agreement on the European Economic Area (EEA) were seen to require that the Norwegian investment fund, which was seen as a comparable entity to a Finnish investment fund, should be treated similarly.

Consequently, the Central Tax Board ruled that the Norwegian investment fund was not liable to pay taxes on dividends received from Finnish listed companies and those dividends were exempt from WHT in Finland. The Central Tax Board's ruling is final as it has not been appealed to the Supreme Administrative Court in Finland.

While every situation still requires case-by-case analysis, this decision further improves the Finnish WHT position of UCITS funds and increases the possibilities of claiming refunds for taxes already withheld. Foreign investment funds that have received dividend income from Finland, can reclaim WHT within five years of the payment.

France

Judgment in the Accor case relating to the French "avoir fiscal" and "précompte mobilier" mechanism

On 15 September 2011, the CJ rendered its decision in the *Accor* case (C-310/09), which relates to the French *avoir fiscal* and *précompte mobilier* mechanism.

For French parent companies benefiting from the participation exemption regime, the *avoir fiscal* (fiscal credit) attached to French-sourced dividends could be offset against the equalization tax due on the redistribution of exempt income (*précompte mobilier*). However, since EU-sourced dividends did not benefit from the *avoir fiscal*, French parent companies receiving EU-sourced dividends could not offset it against the equalization tax due. Both the *avoir fiscal* and the *précompte mobilier* have been abolished by the French Finance Law of 2004. Nevertheless, for years prior to 2004, French companies have challenged the payment of equalization tax for EU-sourced dividends on the grounds of the fundamental freedoms and the Parent-Subsidiary Directive.

Several questions were therefore asked to the CJ by the French Administrative Supreme Court:

- ▶ Is the *précompte* mechanism contrary to the free movement of capital?

- ▶ If so, may the French tax administration refuse to refund the *précompte* paid by the parent company on the grounds that such a refund would constitute an unjust enrichment (i.e. because the *précompte* was not borne by the parent company but by its shareholders)?

- ▶ Do the principles of equivalence and efficiency prevent the French tax administration from requiring the parent company to justify the amount of corporation tax paid by its EU subsidiaries, where such justification is not required for French subsidiaries?

Following the Opinion of the AG released on 22 December 2010, the CJ held that the *avoir fiscal* and the *précompte* restricted the freedom of establishment and the free movement of capital. In particular, the CJ rejected the argument of the French Government, according to which the difference in treatment resulted not from the French rules, but from the decision of the parent company to distribute to its shareholders the dividends received.

The second question related to the fact that the *précompte* was regarded as not borne by the distributing parent company, but borne by its shareholders, since the *précompte* was deducted from the distributed amount. In this respect, the AG considered that the unjust enrichment

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might be extended to situations where the claimant had not borne the economic cost of the tax paid. In the present case, the CJ rejected the unjust enrichment argument since “the national court itself observes that the regime at issue in the main proceedings, which concerns an advance payment made by a parent company when distributing dividends and not a charge levied on the sale of goods, does not lead to the passing on of that advance payment to third parties.”

Answering the third question, relating to the amount of proof to be provided by the parent company in order to evidence the tax borne by its foreign subsidiaries, the CJ first held that the French Supreme Administrative Court would need to decide whether the *avoir fiscal* and *précompte mobilier* mechanism took into account the tax effectively paid by the French subsidiary on its distributed profits. If so, the CJ considered

that the tax authorities might request the parent company to evidence the amount of tax borne by the foreign subsidiaries, except where such evidence would be impossible or excessively difficult to provide in regard, notably, to the rules on conservation of legal documentation existing in the countries of establishment of the subsidiaries.

In light of this decision, one question remains: does the principle of efficiency require that the amount of tax borne by the foreign subsidiaries may be evidenced by the claimant at any stage of the legal proceedings, including in the cases pending before the French Administrative Supreme Court or must such evidence be provided before the decision of the Lower Administrative Court as required under standard French rules? In other words, is it too late for claimants to provide such evidence?

Germany

Taxation: Commission requests Germany to amend discriminatory tax rules on hidden reserves

On 29 September 2011, the EC requested Germany to amend discriminatory tax rules on hidden reserves in cross-border situations.

Section 6b of the German Income Tax Act (*Einkommensteuergesetz*) allows the transfer of hidden reserves from sold assets to newly purchased assets in the case of German real estate or domestic vessels.

A transfer of hidden reserves in the case of reinvestments is only possible if the newly purchased assets are attributable to a permanent establishment in Germany. According to the EC, this constitutes a disadvantage for taxpayers who sell a fixed asset or expand a business to an EU or EEA Member State. The unequal treatment discourages taxpayers from investments in cross-border situations and contravenes the freedom of establishment (Art. 49 TFEU; previously Art. 43 EC Treaty). The Commission does not see a possible justification for this treatment (see press release of the Commission, Date 29/09/2011, IP/11/1127).

Federal Tax Court accepts cross-border fiscal unity (*Organschaft*) for trade tax purposes

Within a fiscal unity (*Organschaft*), the profits and losses in a German group company can be offset against the profits and losses realized by the German parent company or other German companies in the *Organschaft*. In a recent ruling of 9 February 2011 (IR 54, 55/10), the German Federal Tax Court (BFH) accepted an *Organschaft* between a UK parent company and a German subsidiary for trade tax purposes in 1999. This may have far-reaching consequences for the future, if the conclusion and execution of a profit and loss transfer agreement, as a requirement for a German *Organschaft*, should prove not to be in line with EU law.

In a ruling on 9 February 2011 (IR 54, 55/10), the Federal Tax Court recognized a trade tax *Organschaft* between a UK parent company and a German subsidiary company for the year 1999. As the parent company was not managed and controlled in Germany, it could not be a parent company in the *Organschaft*, due to the fact that the wording of the law requires that this must be a resident company.

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The Federal Tax Court sees the strict domestic requirement as an infringement of the non-discrimination rule contained in the tax treaty with the UK. According to that rule, resident companies that are controlled by shareholders resident in the other contracting state may not be placed at a disadvantage for tax purposes, compared with a domestic company controlled by resident shareholders (see also Art. 24 (5) OECD Model Convention). According to the Federal Tax Court, the non-discrimination rule in treaty law prohibits discrimination, even if this results in "non-taxation" in the contracting states concerned. As the *Organschaft* already had to be recognized under treaty law, the Federal Tax Court did not have to deal with its treatment under EU law.

The CJ confirms that the German tax rules leading to a higher taxation in economic terms on outbound portfolio dividends, compared to the taxation on domestic dividend payments, are contrary to the EC Treaty/EEA Agreement.

Summary

On 20 October 2011, the CJ decided, in the infringement proceeding C-284/09 *Commission vs. Germany* that the German tax provisions concerning dividend payments out of portfolio investments are contrary to the TFEU and the EEA Agreement, as Germany taxes dividends paid to foreign companies more heavily in economic terms than dividends paid to domestic companies. According to the CJ, the respective German tax rules restrict the free movement of capital provided for in Art. 63 of the TFEU and Art. 40 of the EEA Agreement.

Background

In July 2007, the EC formally requested Germany to amend its tax legislation regarding outbound dividend payments to companies in the form of a "reasoned opinion" (IP/07/1152). On the basis that the German tax rules had not been amended to comply with the reasoned opinion, the EC had referred Germany to the CJ (C-284/09).

Under German tax law, dividends paid by resident companies (AG, KGaA, GmbH) are generally subject to WHT at a rate of 25%, plus a 5.5% solidarity surcharge.

With respect to outbound dividends, which are not covered by the EC Parent-Subsidiary Directive, the WHT deducted and paid to the German tax authorities, on behalf of the foreign recipients, is automatically regarded as their final German income tax and might only be reduced by an applicable tax treaty. In this context, the German tax law does not yet provide for a tax assessment procedure for the foreign parent corporation.

By contrast, Germany provides for a 95% tax exemption for dividends paid to a domestic corporate shareholder. Any domestic parent corporation receiving dividends is, therefore, generally eligible to apply for a tax credit with respect to the paid amount of WHT or to claim a respective refund.

As a result, German tax rules may lead to outbound dividends being taxed at a higher rate than domestic dividends in certain cases. This discrimination concerns outbound dividends out of portfolio investments paid to corporate shareholders in EU Member States and to those EEA/European Free Trade Association (EFTA) countries that provide appropriate assistance. Consequently, the CJ confirms that the German tax rules create a restriction of the free movement of capital as stipulated under Art. 63 of the TFEU and Art. 40 of the EEA Agreement.

The mere reference to a relief system applicable in a tax treaty, i.e., the reduction of the WHT and a credit relief, is not sufficient if, as a result, the tax burden in economic terms is still heavier compared with a domestic situation. Moreover, to find the correct comparable, the Court did not consider the level of taxation of the shareholders; a fact that the French Supreme Administrative Court recently posed in a preliminary question to the CJ in the still-pending case (see *EU Alert* No. 168), albeit in a case involving an investment fund.

The CJ did dismiss all justifications brought forward by Germany: for example, the reduction of tax revenue, the reference to domestic dividends being covered by local business tax as well as the coherence of the tax system.

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The decision fits very well in a series of previous CJ cases. The CJ primarily confirmed the principle that outbound dividends paid to foreign corporate parent entities may not be subject to higher taxation in the source state than domestic dividends in its *Denkavit* decision of 14 December 2006 (C-170/05) and in its *Amurta* decision of 8 November 2007 (C-379/05). The EFTA Court also provided for a comparable decision about the incompatibility of the Norwegian WHT provisions with Art. 40 of the EEA Agreement on 23 November 2004 (E-1/04).

In recent years, the CJ decided, in the *Commission vs. Italian Republic* case dated 19 November 2009 (C-540/07), that the current Italian dividend taxation method is not compatible with the free movement of capital pursuant to Art. 63 of the TFEU, as dividends distributed to a resident shareholder are taxed lower than dividend distributions to a non-resident shareholder. In addition, the CJ decided that the Spanish dividend taxation system infringes the free movement of capital (Art. 63 of the TFEU, formerly Art. 56 EC Treaty), since the Spanish law exempts dividend distributions to non-resident parent companies where at least 10% (15% before 1 January 2009; and 20% before 1 January 2007) shareholding was held in the Spanish subsidiary,

whereas dividends distributed to resident corporations were not subject to tax, if the shareholding was at least 5% (*Commission vs. the Kingdom of Spain*, C-487/08).

Implications

The decision of the CJ shows that the discrimination of outbound dividends is not primarily based on the levy of WHT, as the German tax law does not formally differentiate between payments to domestic and foreign shareholders for WHT purposes. Rather, the unequal treatment is based on the grounds that the WHT liability of foreign parent corporations of domestic subsidiaries becomes final, while domestic parent companies benefit from participating in the exemption system.

According to reports, the German Federal Ministry of Finance will soon issue a Decree with respect to the CJ's judgment. The German Government might react by amending its current WHT provisions to provide foreign parent corporation access to the participation exemption and establishing respective tax assessment rules for foreign corporate shareholders. Another possibility would be the introduction of a minimum shareholding requirement of 10% into the current German participation exemption.

Hungary

Hungarian telecom tax: contrary to EU rules?

In October 2010, Hungary introduced specific turnover taxes on three industries, including telecom operators. The telecom tax constitutes a HUF60b (approximately €200m) tax burden for the industry and reduces the sector's profit by almost 70%.

The entities that are subject to the tax are: resident legal persons, other organizations, individual entrepreneurs and non-resident entities and individuals with Hungarian branches, as well as individuals who were providing telecom services on 1 October 2010. The tax is levied on net sales revenues from telecom activities. The rate varies from 0% to 6.5%.

At the end of September 2011, after a long period of negotiation, the EC requested that Hungary abolish the telecom tax on the grounds that it infringes EU telecom rules. According to EC Directive 2002/20/EC, Member States may not levy taxes specific to the telecom industry, except for administrative charges that may be imposed on providers of electronic communication services, in order to finance certain activities of the national authorities that regulate telecom services. Such charges cannot exceed the actual administrative costs of the authorities. However, according to the Commission's reasoning, revenue from the Hungarian telecom tax is channeled into the central budget and is not used to cover the specific costs of regulating the telecom sector.

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Furthermore, the Commission deems that Hungary also failed to comply with its obligation to consult the interested parties regarding the charges levied on telecom operators. The Hungarian Government rejected the Commission's request to abolish the telecom tax and stated that the Directive did not contain any restrictions relating to telecom tax and that Member

States retain the right to impose direct taxes.

The Commission expressed hope that the dispute could be settled without having to refer Hungary to the CJ; however, the Government's press release states that it is ready to defend its opinion before the Court.

Luxembourg

Migration to an EU country leads to increase in net worth tax (NWT) - Luxembourg referred to the CJ

Under the Luxembourg law, a reduction of NWT for a given tax year is granted to Luxembourg resident companies upon request, provided that certain conditions are met. In order to benefit from this NWT reduction, the Luxembourg company needs to allocate a certain amount to an NWT reserve that needs to be maintained for five tax years. The reduction amounts to one-fifth of the NWT reserve, but is limited to the amount of the corporate income tax due by the company during the same tax year.

On 15 October 2010, a Luxembourg company filed an appeal with the Luxembourg Administrative Court of First Instance (case no. 27380) against a decision by the Luxembourg tax authorities. The company had booked an NWT Reserve for the tax years 2004, 2005 and 2006, and benefited from a reduction of its NWT due for these years under the conditions mentioned above. At the end of 2006, the company migrated to Italy and was subsequently absorbed by another Italian company. Given that the company was not subject to Luxembourg NWT further to its migration to Italy, the Luxembourg tax authorities denied the benefit of the NWT reduction. The authorities argued that the NWT reserve had not been maintained at the level of the company for five tax years as required by Luxembourg law. However, the company maintained this NWT reserve in its books after the migration to Italy. The NWT reserve was also maintained after the merger at the level of the absorbing entity. The tax authorities argued that the law required that the company be

a Luxembourg resident during the five-year period during which the NWT reserve needs to be maintained.

In the company's view, the requirement to remain a resident during the five-year period during which the NWT reserve needs to be maintained infringes the freedom of establishment within the EU as provided for by Art. 49 of the TFEU (formerly Art. 43 EC Treaty).

On 13 July 2011, the Luxembourg Administrative Court referred the case to the CJ, asking the Court to decide whether the relevant Luxembourg provision is contrary to the freedom of establishment.

Draft law related to mutual assistance for collection of taxes within the EU

On 12 September 2011, a draft law relating to the implementation in Luxembourg law, the Directive of 16 March 2010 (2010/24/EU) for the mutual assistance between EU Member States for collection of taxes within the EU was submitted to the Luxembourg Parliament. This draft law aims at implementing Directive 2010/24/EU with effect from 1 January 2012. Luxembourg has already implemented the previous Directives. The draft law is broader in scope than the previous law on mutual assistance by covering, in particular, all taxes levied in Luxembourg and taxes levied in the other EU Member States as referred to in Directive 2010/24/EU, as well as late interest due in relation to these taxes. The draft law also introduces a collection threshold of €1,500, below which no assistance related to the collection will be granted.

Netherlands

Dutch Ministry of Finance proposes extension of the dividend WHT refund procedure to cover non-EU investors

On 15 September 2011, the Netherlands budget plan 2012 was released. One of the proposed measures is that tax-exempt legal entities established in non-EU countries, such as pension funds, certain sovereign wealth funds and other governmental bodies, may be entitled to a full refund of Dutch WHT tax levied on their Dutch portfolio investments. This refund would be granted upon certain conditions being met.

The first is the condition that an international arrangement should apply between the Netherlands and the non-EU country at hand, which provides for international exchange of information. The second condition is that the legal entity would have been tax-exempt in the Netherlands if it was established there. A statutory time limit of three years will also apply. The primary reason for this extension seems to be an acknowledgment by the Dutch Government that there is uncertainty as to whether current legislation complies with the free movement of capital under Art. 63 of the TFEU (previously, Art. 56 EC Treaty). In addition, the Government has stated that this measure will make the Netherlands a more attractive jurisdiction for investors. A list of qualifying non-EU countries will be published in due course and the proposal should become effective on 1 January 2012, after approval in the Dutch Parliament.

The proposed extension to non-EU situations, once again, demonstrates the significant impact that the fundamental freedoms, especially the free movement of capital, have on Member States' WHT systems.

Dutch corporate exit taxation incompatible with EU law, says AG

On 8 September 2011, AG Kokott delivered her Opinion in the Dutch case of *National Grid Indus BV* (C-371/10). In this case, the key question was whether the Dutch corporate exit tax upon the transfer of seat of a company from the Netherlands to UK contradicts the freedom of establishment. The AG's Opinion was that it does.

National Grid Indus BV is a limited liability company that transferred its effective place of management from the Netherlands to the UK. At the time of transfer, the company owned a substantial group receivable, denominated in British pounds. As the British pound had strengthened against the euro, the value of the receivable had increased and a substantial unrealized currency gain rested on the loan receivable. On the date of the transfer, the unrealized currency gain was assessed, based on the exit tax provisions incorporated in the Dutch Corporate Income Tax Act. *National Grid Indus BV* lodged an appeal against tax levied on this unrealized currency gain, arguing that the Dutch corporate exit taxation provision infringes the freedom of establishment under Art. 49 of the TFEU.

According to the AG, the immediate taxation of unrealized profits upon transfer of seat of a company is incompatible with the freedom of establishment. Any such taxation should be deferred until the time of the actual realization of profits. The AG made, however, one exception: that such exit taxation can be justified if it is not reasonably possible – given the complex nature of the enterprise's assets – to determine the exact point in time that the profits accrued prior to the transfer of seat (and are subsequently realized after the transfer of seat). In such cases, the Dutch exit tax is permissible. Since *National Grid Indus BV* only holds one group receivable denominated in British pounds, the AG concluded that immediate taxation of the unrealized currency gain on this receivable infringes the freedom of establishment. The Netherlands should, thus, defer taxation until the actual moment of realization of the currency gain. In addition, the Netherlands should also take into account possible currency losses on the group receivable that accrued between the moment of transfer of seat and actual realization, as such currency loss will not be recognized in the UK.

The Opinion of the AG must be welcomed to the extent that it facilitates corporate mobility within the Union. It seeks to find a fair balance between the interests of fair competition between companies on

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the one hand and the budgetary interests of Member States on the other. Nonetheless, the exception made by the AG for certain types of enterprises with complex assets will, in all likelihood, raise many new questions. Since the Opinion is not binding upon the CJ, it remains uncertain whether the Dutch exit tax upon

transfer of seat is compatible with the freedom of establishment, at least until the CJ issues its judgment in the *National Grid Indus BV* case. The final word now lies with the CJ which, through this case, has the opportunity to set binding standards on the way exit taxes can be charged.

Norway

Norwegian National Budget 2012 introduces changes to the Norwegian Tax Law

The National Budget for 2012 was presented on 6 October 2011. The main changes proposed by the Norwegian Ministry of Finance regarding corporate taxation in Norway are given below.

1. Amendments to the 3% rule under the Norwegian participation exemption method

The 3% rule under the Norwegian participation exemption entails that 3% of dividends and gains on shares qualifying for the Norwegian participation exemption is included as taxable income and subject to 28% corporate taxation in Norway. Thus, only 97% of the qualifying income is currently tax-free in Norway. The purpose of the 3% rule is to reverse the deduction of expenses incurred with respect to the tax-exempt income.

In the National Budget, the Norwegian Ministry of Finance has proposed the following changes to the 3% rule, with effect from 1 January 2012:

1.1 Capital gains will no longer be covered by the 3% rule

It is proposed that the 3% rule will no longer apply to gains upon transfer of shares. This means that capital gains derived from the sale of shares in limited liability companies and partnerships, etc., which are qualifying companies under the exemption rules, will be completely tax-exempt in Norway. The amendment will apply regardless of whether the exempt gain is derived from a Norwegian company or a company tax resident abroad.

1.2 Intra-group dividend distributions will no longer be covered by the 3% rule

It is proposed that dividends received from Norwegian group companies will no longer be covered by the 3% rule. Accordingly, dividend distributed between group companies

that are covered by the Norwegian group contribution rules, will be tax-exempt in the hands of the receiving company.

To prevent conflict with the obligations of Norway under the EEA Agreement, it has been proposed that the exemption will also apply to dividend distributions to or from group companies resident in another EEA state, provided that the foreign company is equivalent to a Norwegian company covered by the exemption, and that the foreign company has qualifying substance (i.e., genuinely established and performs real business activities) in the other EEA state.

For distributions to companies tax resident within the EEA, the exemption will only have tax implications if the foreign company is engaged in taxable activities in Norway (through a permanent establishment) and the shares can be allocated to the Norwegian permanent establishment. Distributions to EU/EEA group companies (without a place of business in Norway) are currently WHT exempt and the 3% rule is not applicable in these situations.

The reason behind the proposed amendment is that Norwegian group companies may elect to distribute profits through a group contribution instead of as dividend distributions, in order to avoid the company receiving the dividends having to include, and tax, 3% of the dividend as income. In the budget proposal, the Ministry of Finance has stated that the form for carrying out a dividend distribution should not be decisive in order to determine whether a tax should be imposed according to the 3% rule.

1.3 The 3% rule will also apply to tax-exempt distributions from partnerships

It is proposed that the 3% rule will also apply to profit distributions from partnerships. Currently, the tax exemption for income

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distributions from a partnership is regulated by Chapter 10 of the Norwegian Tax Act and not by the participation exemption rules. For this reason, such distributions are currently not subject to the 3% rule.

The taxable income of a partnership is calculated at the partnership level, and the result is allocated to the partners and taxed in their hands. Hence, the Norwegian group contribution rules are neither applicable nor necessary. However, the introduction of the 3% rule on income distributions from a partnership implies that 3% of distributions from the partnerships will always be included as income in the hands of the corporate recipient (i.e., the proposed group exemption referred to above will not be applicable). As a result, there will be an asymmetric treatment between limited liability companies and partnerships that, this time, is in favor of the limited liability companies.

1.4 Broadening the scope of the 3% rule to cover dividends received by foreign companies with a permanent establishment in Norway

Foreign companies are, in general, not covered by the 3% rule, as they will not normally have the right to deduct expenses incurred with respect to tax-exempt income covered by the Norwegian participation exemption.

However, if the foreign company has a permanent establishment in Norway and shares for example are owned in connection with the permanent establishment, the business will have the right to deduct the expenses incurred in relation to the share holding. The Ministry, therefore, proposes to broaden the scope of the 3% rule to cover distributions of dividends

to foreign companies (resident both inside and outside the EU/EEA) with a permanent establishment in Norway.

2. Limitation on the deductibility of losses incurred on debt receivables between related companies

With effect from 6 October 2011, the Norwegian Ministry of Finance has proposed to limit the right for companies to deduct bad debts between related parties. The limitation does not apply to customer debt, bad debts that represent previously taxed income by the creditor and debt receivables arising from mergers and demergers.

The purpose of the limitation is to limit the asymmetric effects of the Norwegian participation exemption on equity financing and debt financing. The asymmetry arises from the fact that income derived from shares under the participation exemption in general is tax-exempt, while losses on debt receivables are deductible, provided that certain requirements are met. As a result, a company may be financed with a small amount of equity and larger amounts of debt and, depending on the company's results, the credit company may either deduct the loss incurred on the debt receivable or receive tax-exempt dividend distributions and tax-exempt gains.

3. Distribution tax on untaxed capital (equalization tax) will no longer be applicable

Under current domestic tax law, Norway may levy a distribution tax on untaxed capital when it is distributed to the shareholders.

Effective from the fiscal year 2012, it is proposed that the rules regarding distribution tax on untaxed capital will be abolished.

United Kingdom

Decision of Court of Appeal in the *Marks & Spencer* case

On 14 October 2011, the Court of Appeal's judgment in the *Marks & Spencer* case ([2011] EWCA Civ 1156.) was released. The Court of Appeal considered several questions concerning the "no possibilities" test and the timing for cross-border group relief claims, as well as methods for calculating overseas losses for UK group relief purposes.

The Court of Appeal agreed with earlier decisions of UK courts and held that the no possibilities test should be applied at the date of the claim, rather than at the end of the accounting period in which the losses crystallized.

The Court noted that, if a surrendering company can utilize only part of its losses against profits in its home country, the

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UK claimant company should be entitled to claim group relief in relation to the unrelieved part of the losses. The Court found it unacceptable to exclude all losses from group relief in the UK, simply because there is a possibility that a small amount of losses may still be utilized overseas.

In addition, the Court of Appeal agreed with earlier decisions of the UK courts that the following method to calculate the amount of losses available for UK group relief purposes is in line with the principles of EU law:

1. Taxable losses should be identified under local law to determine the amounts, if any, that have been or could be used in the overseas territory.
2. Taxable losses (calculated under the tax rules of the overseas territory) available to be used against any subsequently

earned profits in the local territory should be identified on a first-in, first-out basis.

3. A figure to which UK tax law may be applied should be calculated by determining the amounts that would equate to the commercial profit or loss in the statutory accounts (by removing the adjustments made to the local profits in overseas territory or losses for the purposes of step 1).
4. UK tax adjustments should be applied to the commercial profits or losses identified at step 3 to arrive at an equivalent UK taxable loss.
5. The figure identified at step 4 should be reduced by the amount of overseas losses utilized at step 2.

The result is the amount available for group relief in the UK.

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EYG no: DL0507

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