

## An Italian Perspective on Recent ECJ Direct Tax Decisions

by Rossi Q. Marco

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# SPECIAL REPORTS

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## An Italian Perspective on Recent ECJ Direct Tax Decisions

by Marco Q. Rossi

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In 2007 the European Court of Justice continued its work of assessing the compatibility of EU member states' national tax laws with the EC Treaty's fundamental freedoms.

It delivered important decisions on several issues, including withholding tax on outbound dividends, cross-border losses and group relief, the relationship between the free movement of capital and the freedom of establishment, the exact scope of free movement of capital in transactions with third countries, and fiscal supervision as a justification for restrictive tax measures.

This article will briefly analyze some of those decisions and discuss how they fit within the ECJ's case law on direct taxes. The article will also discuss the impact that the ECJ's decisions have had on certain aspects of Italian corporate income tax laws regarding interest for foreign investors in Italy.

The objective is to understand whether the cases reflect a new tax policy approach aimed at furthering the objective of eliminating tax barriers to EU cross-border business without dismantling member states' income taxes or trampling on member states' sovereignty on direct tax matters, or whether the cases continue an aggressive approach of enforcing EU law — to force other political branches of the EU to move toward corporate tax rate harmonization at the cost of denying member states' ability to protect their tax base and subverting generally accepted principles of international tax law.

My tentative conclusion after my analysis is that the ECJ might seem to have adopted a more lenient approach toward allowing member states to protect their

tax base without creating unacceptable barriers to trade and investment within the EU. If this were actually the case, it would be a wise decision.

### I. Background

Before discussing the recent ECJ decisions in the area of direct taxes, it is useful to provide a brief overview of the various steps that led to the creation of the EU and the general role and functions of the ECJ, which is the judicial body of the EU.

The process toward the creation and enlargement of the EU is remarkable, and the EU is a great success story. However, the impact of the EU on the income tax systems of member states, because of the ECJ's aggressive position in direct tax matters, was unexpected and underestimated.

The member states intended to maintain their exclusive sovereignty on income taxes while relinquishing most of their budgetary and (for those that adopted the common currency) monetary policy powers to the EU. Consequently, the turmoil and protest that follows each major decision of the ECJ on income taxes is not a surprise.

#### A. Road Map to the EU

Below is a brief summary of the key steps that led to the creation and enlargement of the EU over the last 50 years.

**1951:** The Treaty of Paris established the European Coal and Steel Community (ECSC), whose initial members were Belgium, France, (West) Germany, Italy, Luxembourg, and the Netherlands. The ECSC established the first European tax (the ECSC levy) and

eliminated trade barriers on coal and iron among member states. Appeals under the Treaty of Paris could be brought to the ECSC Court of Justice, which was established in 1952 (and is the predecessor of today's ECJ). The Treaty of Paris expired in 2002.

**1957:** The six ECSC member states signed the Treaties of Rome, establishing the European Economic Community (EEC) and the European Atomic Energy Community (EURATOM). The objective of the new European Communities was to expand areas of cooperation and ultimately establish a common European market for the free exchange of goods and services among member states.

**1958:** The new European Court of Justice was established, replacing the ECSC Court of Justice.

**1967:** A single Commission, Council of Ministers, and European Parliament served all three European communities.

**1973:** Denmark, Ireland, and the United Kingdom joined the European Communities.

**1981:** Greece joined the European Communities.

**1986:** Spain and Portugal joined the European Communities. Also, the member states signed the Single European Act, designed to accelerate the creation of a single European market.

**1992:** The member states signed the Maastricht Treaty. The Maastricht Treaty changed the name of the European Economic Community to simply "the European Community." It also introduced new forms of cooperation between the member state governments. By adding this intergovernmental cooperation to the existing Community system, the Maastricht Treaty created a new structure with three pillars, which is the European Union.

**1995:** Austria, Finland, and Sweden joined the EU.

**1999:** The Treaty of Amsterdam, signed in 1997, entered into force. It consolidated and renumbered the EU and EC Treaties.

**2002:** Twelve of the EU member states adopted the euro as their sole currency.

**2003:** The Treaty of Nice, signed in 2001, entered into force. It dealt mostly with reforming the institutions so that the EU could function efficiently after its enlargement to 25 member states. With the Treaty of Nice, the former Treaty of the EU and the Treaty of the EC have been merged into one consolidated version. The Treaty of Nice streamlined the EU decision-making process in preparation for the accession to the EU by other European countries. Under a proposal from the commission, most of the council's decisions can be taken by a qualified majority vote, although tax matters still require unanimous decisions.

**2004:** Ten new countries — Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia — joined the EU. Also, a "treaty establishing a constitution for Europe" was

adopted by the heads of state and government at the Brussels European Council on June 17-18, 2004, and signed in Rome on October 29, 2004, but it was never ratified.

**2006:** Romania and Bulgaria joined the EU, bringing the total number of EU member states to 27.

**2007:** The Treaty of Lisbon was signed on December 13, 2007. It must be ratified by all 27 member states before it can enter into force, which is hoped to be before the next European Parliament elections in June 2009. Its main objectives are to make the EU more democratic, meeting the European citizens' expectations for high standards of accountability, openness, transparency, and participation; and to make the EU more efficient and able to tackle today's global challenges such as climate change, security, and sustainable development.

**2008:** Turkey and Croatia applied for and are engaged in the process of becoming the next EU member states.

## B. EU Institutions

### 1. European Parliament

The European Parliament is the only EU institution whose members are democratically elected directly by EU citizens. Parliament members sit for five-year terms according to political party, not nationality. The European Parliament's powers have grown with each successive treaty and, together with the EU Council of Ministers, it has the power to legislate on matters of EU competence and to approve the EU budget.

Most EU legislation falls under the codecision procedure provided by article 251 EC, in which the Parliament and Council share legislative power. The commission has the authority to propose legislation but the Parliament and the Council must agree on the legislation for it to pass.

However, for legislation on taxation, the Parliament only has consultation powers. Under this procedure, the Parliament only has the right to submit its opinions on legislation proposed by the commission and to propose amendments to pending legislation, which are subject to the commission's approval.

The Parliament also has the responsibility to supervise the other EU institutions and to approve the nomination of the president and other members of the commission. The Parliament also must approve the accession of other countries as member states, and it shares budgetary powers with the commission and the council.

### 2. EU Council of Ministers

The Council of Ministers is the main decision-making body of the EU. Its members are national ministers appointed to the council by the government of each member state in each specific area. For example, the EU Council of Economic and Finance Ministers is

made up of each member state's finance minister and is responsible for taxation matters.

The EU Council of Ministers votes on decisions by simple majority, qualified majority, or unanimity, depending on specific matters within the jurisdiction of the EU. In the area of taxation, unanimous voting is always required. As previously discussed, the Parliament only has a right of consultation in tax matters. EU legislation in the area of direct taxation takes the form of various council directives adopted under the authority of article 94 of the EC Treaty.

Article 94 gives the EU Council of Ministers, acting unanimously on a proposal by the commission and after consultation with the Parliament, the power to issue directives "for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the common market." Council directives issued in the area of direct taxation include the parent-subsidiary directive, the merger directive, the interest and royalty directive, the savings tax directive, and the mutual assistance directive.

### 3. European Commission

The European Commission is the EU executive body and acts by majority of its members on behalf of the EU as a whole. The commission has the responsibility of proposing legislation to the Parliament and the council, implementing the EU policy and budget, and enforcing EU law (together with the ECJ).

The commission has 27 commissioners (one from each member state) who are appointed for a five-year term (with the consent of the Parliament) and work independently of their member states.

In addition to proposing legislation, the commission has a primary role in enforcing EU law as it relates to direct taxation.

## The European Commission has a primary role in enforcing EU law as it relates to direct taxation.

If the commission finds that a member state has failed to fulfill its obligations under EU law, the commission is empowered to start a notification procedure by issuing a notice of noncompliance to the member state and, ultimately, to bring an action against that member state before the ECJ.

The commission has used its authority to sue member states on tax matters in cases such as *avois fiscal* and is continuing to press member states to change

their domestic tax laws to the extent that they do not conform to the EC Treaty provisions as interpreted by the ECJ.

The commission can also sue a member state for failing to properly repeal or amend domestic tax legislation previously struck down as illegal by the ECJ.

As an example of the powers exercised by the commission in the area of direct taxes, the commission recently issued to Portugal a formal request to amend its legislation concerning the tax rules applicable to investments held in financial institutions established outside Portugal.

The income flowing from these investments may, in some cases, be more heavily taxed than the income from domestic investments held in Portugal.<sup>1</sup> The commission considered that these rules are incompatible with the EC Treaty, which guarantees the free movement of capital. The request was in the form of a reasoned opinion under article 226 of the EC Treaty. If Portugal does not reply satisfactorily to the reasoned opinion within two months from receipt, the commission may refer the matter to the ECJ.

Similarly, the commission has issued to Spain a formal request to amend Spanish discriminatory antiabuse rules in the corporate tax area, according to which income originating from specific member states or territories of the EU qualified as tax havens is taxed more heavily than domestic income. The commission considered these rules incompatible with the freedoms of the EC Treaty. This request was also in the form of a reasoned opinion, the second stage of the infringement procedure under article 226 of the EC Treaty. If Spain does not amend its law within two months, the commission may refer the case to the ECJ.

Commissioner for Taxation and Customs Union László Kovács said:

I understand that Member States need to ensure that their tax bases are not unduly eroded because of abusive and overtly aggressive tax planning schemes, but the Commission as Guardian of the Treaties cannot tolerate disproportionate obstacles to cross-border activity within the EU.

<sup>1</sup>According to Portuguese rules, capital income derived either from a national or foreign source is subject to final withholding tax of 20 percent. However, for some categories of capital income, resident taxpayers can opt for taxation under the progressive tax rates. Progressive tax rates imposed on the income of individuals range from 10.5 percent to 42 percent. Accordingly, for many people (those whose marginal rate of tax is lower than 20 percent), the fiscal treatment of the income obtained from financial investment within the Portuguese territory results in a lower tax burden than that imposed on income flowing from investment held outside Portugal.

He added:

The infringement at stake again reveals that there is a need for better coordination of national anti-abuse tax rules as the Commission stressed in its December 2007 Communication on anti-abuse rules in the area of direct taxes. I invite all Member States (and not only Spain) to explore the scope for constructive and coordinated responses which would strike a proper balance between the protection of national tax bases and the need to observe the freedoms of the Treaties.

The commission resolved to provide more guidance to the member states on how ECJ decisions on tax matters should be implemented to achieve uniformity, and in December 2007 it recommended that all member states revise their domestic antiabuse legislations to make sure they are consistent with the antiabuse standard adopted by the ECJ in *Cadbury Schweppes* (the “wholly artificial arrangement” test).

#### 4. European Court of Justice

The ECJ is in charge of the uniform interpretation and application of EU law (the EC Treaty and secondary EU law adopted by the council and the Parliament in the form of directives or regulations) that will be applied by national courts of member states. Therefore, it hears cases involving disputes on the interpretation and implementation of EU law referred to it by national courts.

The ECJ consists of one judge from each member state. Eight advocates general assist the Court and issue unbiased opinions on cases brought before it. In the majority of cases, the ECJ rules consistently with the opinion of the advocate general. Generally, a panel of three to five judges hears cases, although the full Court may hear the most important cases. Decisions are taken by majority vote and no dissenting or concurring opinions are written. The full Court, as opposed to a single judge or judges, issues the final decision of the case.

Both ECJ judges and advocate generals serve independently from their member states for a six-year term. They can be confirmed for up to two three-year terms, for a total of 12 years of service.

There are two main types of action that can be brought before the ECJ: an action against a member state for failing to fulfill an obligation under EU law, and references from national courts of the member states for preliminary rulings on interpretation of EU law that is relevant for the decision of a case tried before a national court.

Actions for a member state’s failure to fulfill an obligation under the EC Treaty may be brought by the commission or by another member state. Before bringing such actions, the commission must notify the accused member state and issue a reasoned opinion on the matter. If the member state does not comply with

the EU law as requested by the commission, the commission may sue it before the ECJ.

In the direct taxes area, most of the ECJ cases have been referred to the ECJ as requests for a preliminary ruling. In cases when a national court is unsure of how EU law should apply, it may refer questions to the ECJ for a preliminary ruling on the interpretation or application of the relevant EU law under article 234 of the EC Treaty. A national court may only make a reference for preliminary ruling to the ECJ when the court considers the interpretation of EU law necessary for rendering a decision on a pending case. Lower courts may refer such questions to the ECJ, while a court whose judgment is not subject to appeal to a higher court must refer such questions, unless the ECJ has already ruled on the matter or the correct interpretation of EU law is obvious.

Under article 234 of the EC Treaty, the ECJ has jurisdiction to grant preliminary rulings on the interpretation of the EC Treaty on the validity of administrative actions taken by the other EU institutions and central bank, and on the EU law provisions enacted by the council.

By referring a case to the ECJ for a preliminary ruling, the national court of a member state asks the ECJ for a binding interpretation of EU law as it relates to litigation pending before the national court. Typically, the issue is whether the domestic law that applies to a case is compatible with EU law, and the ECJ is requested to give a clear interpretation of EU law that can be used by the national court to resolve the case it is trying. Once the ECJ has given its interpretation of the relevant EU law, the case is remanded to the national court, which is responsible to the final decision of the case.

The ECJ interpretation of EU law is binding for both the member state whose court made the referral to the ECJ and for any other member states that operate the same law that poses a similar issue. As a result, other member states frequently join a case before the ECJ and file amicus briefs to defend the position of the member state involved.

The ECJ does not decide the case pending before the national court that requested the ruling. Instead, the ECJ gives the interpretation of what is required under EU law, and it remands the case to the national court, which must rule on the face of the decision rendered by the ECJ.

ECJ rulings interpreting and applying the EC Treaty’s provisions constitute primary EU law and have the same standing as the EC Treaty itself. They are binding on the domestic courts of each member state, and member states are obliged to adjust their national laws accordingly. A member state’s failure to comply with ECJ rulings is a violation of EU law and may constitute the legal basis for bringing a claim for

damages against a member state by an individual or legal body resident in that member state.

## II. EC Jurisdiction on Taxes

### A. Indirect Taxes

The EU is responsible for the harmonization of indirect taxes on the transfer of goods and services. For this purpose, the EU enacted common VAT rules in a directive adopted in 1977, which has been enacted in all member states.

The tax provisions of the EC Treaty are set forth in Title VI, Section II, Chapter 2. The provisions concern indirect taxes charged on the exchange of goods and services within the EU.

Article 90 of the EC Treaty provides that “no Member State shall impose, directly or indirectly, on the products of other Member States any internal taxation of any kind in excess of that imposed directly or indirectly on similar domestic products” and that “no Member State shall impose on the products of other Member States any internal taxation of such a nature as to afford indirect protection to other products.” Article 91 of the EC Treaty prohibits the grant of indirect subsidies on the export of goods to other member states in the form of internal tax rebates exceeding the amount of internal taxes actually charged on those products.

Article 93 of the EC Treaty provides that:

The Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament and the Economic and Social Committee, adopt provisions for the harmonization of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonization is necessary to ensure the establishment and the functioning of the internal market within the time limit laid down in Article 14.

### B. Direct Taxes

Unlike indirect taxes, direct taxes do not directly fall under the jurisdiction of the EU. Likewise, harmonization in the area of direct taxes is not one of the objectives of the EU. As a consequence, jurisdiction on direct taxation matters is reserved in principle to the member states.

Under article 94 of the EC Treaty, the EU Council of Ministers by unanimous vote can adopt directives for the approximation of laws, regulations, or administrative provisions that directly affect the establishment or functioning of the common market. Under the narrow authority granted under article 94 of the EC Treaty, the EU Council adopted the parent-subsidiary directive and the merger directive in 1990, and the interest and royalties directive and savings tax directive in 2003.

Article 293 of the EC Treaty provides that member states will enter into negotiations with a view of avoiding double taxation within the EU.

From a literal reading of the EC Treaty, it appeared that the role of the EU in the area of direct taxation would be limited, aimed only at procuring some sort of approximation of different national tax laws, to the extent that this was necessary to achieve the creation of a single market, and always through a unanimous vote in the EU Council of Ministers.

ECJ case law on direct taxes of the last 20 years has proved that this perception could not have been further from the truth.

## III. ECJ Case Law on Direct Taxation

### A. Power of Judicial Review

As we have seen, except for some tax measures adopted by unanimous vote by the EC Council, there is no EU law governing direct taxation; consequently, jurisdiction on direct taxation matters is reserved for the exclusive competence of the member states.

However, the ECJ held that member states must exercise their competence in the area of direct taxes consistently with the general principles of EU law, including the EC Treaty provisions on nondiscrimination and the fundamental freedoms of establishment, provision of services, and movement of workers and capital, on which the functioning of the internal market is based.

In a landmark decision issued in 1986 in the *avoir fiscal* case (*Commission v. France* (C-270/83)), the ECJ reclaimed its power of judicial review on national income tax laws to determine whether they actually conform to EU law. At the time, nobody paid attention.

Since it affirmed its power of judicial review of member states' domestic legislation on direct taxes, the ECJ rendered about 100 decisions in matters involving direct taxation, which had a continuing and profound impact on member states' tax laws.

The four freedoms under which the ECJ tests the compatibility of national tax laws with EU law are the freedom of movement of workers, the freedom of establishment, the free movement of capital, and the freedom of services. These freedoms incorporate the overriding principle of nondiscrimination, which is also codified separately in article 12 of the EC Treaty.

### B. Freedom of Movement of Workers

The freedom of movement of workers is codified in article 39 of the EC Treaty. It applies to employees and dependent contractors and abolishes national discrimination against nationals of other member states for “employment, remuneration, and other conditions of work and employment.” National tax laws that provide for a different tax treatment of workers who are nationals or residents of a member state and those of

other member states have the potential to be discriminatory and can be challenged under article 39.

### C. Freedom of Establishment

Article 43 of the EC Treaty sets forth the freedom of establishment in the following terms:

Restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State.

Under article 48 of the EC Treaty, the freedom of establishment applies to companies as well as to individuals (both self-employed and independent contractors).

### D. Freedom of Services

Article 49 of the EC Treaty prohibits member states from imposing restrictions on the freedom to provide services. It applies to services provided in another member state or to nationals of another member state.

### E. Free Movement of Capital

Article 56 of the EC Treaty prohibits “all restrictions on the movement of capital between Member States and between Member States and third countries.” The free movement of capital protects nationals and residents of a member state who want to invest capital outside of their residence state or want to raise capital from third-country investors. Therefore, it applies to both inflows of capital from foreign countries and to outflows of capital from the EU.

The article requires that the same tax treatment apply, in comparable situations, to income earned from outbound investments by residents of the member states and to income earned from inbound investments by residents of third countries.

### F. Relationships Between Freedoms

Direct investments that grant a “definite influence” over a company’s decisions and the ability to determine its activities are covered by the freedom of establishment clause of article 43. Free movement of capital applies to both direct and portfolio investments when the size of the investment or the shareholding does not matter. Which freedom applies in a particular case depends on the purpose of the national tax rules that govern that case.

The freedom of establishment applies only within the EU, while the freedom of movement of capital applies also to transactions with third countries.

The four freedoms and the overriding nondiscrimination principle incorporated in each of them protect against discrimination by the home member state as well by the host member state.

### G. Discrimination, Justification, Proportionality

The ECJ case law on direct taxes follows a general pattern.

First, the ECJ determines whether the national tax rules are discriminatory or unlawfully restrict one or more of the fundamental freedoms. Even a minimum obstacle or a minor difference in the tax treatment between an internal and a cross-border transaction can amount to a prohibited discrimination. If the tax measure is not found discriminatory or restrictive, the case ends there.

## The flow of ECJ decisions on direct taxes has accelerated dramatically in the last five or six years.

If it finds a restriction, the ECJ then considers whether that restriction can be justified by the overriding principles of public interest. The ECJ has considered various potential justifications to discriminatory tax measures, including fiscal cohesion of the tax system, protection of taxing rights, the fight against tax evasion or abuse, and proper allocation of taxing powers between member states. In a few cases a discriminatory tax provision withstood scrutiny under the above exceptions.

If a restriction of a fundamental freedom is considered justified, the restrictive provision must still comply with the proportionality principle, which means it cannot exceed what is strictly necessary to achieve the justified objective. The ECJ has said it must be “appropriate for securing the attainment of the objective it pursues and it must not go beyond what is necessary.” If a restrictive provision is too broad, even though it is designed to achieve a legitimate goal it still violates the EC Treaty and can be struck down.

### H. Effects of ECJ Decisions

ECJ decisions have retroactive effect. If a tax is eliminated because it is incompatible with the EC Treaty, taxpayers are entitled to a refund for any taxes paid under the tax provision declared invalid (provided the deadline for filing a refund claim as provided for under the member state’s domestic tax laws has not already expired).

Only in exceptional circumstances (such as when a member state’s budget is at risk as a result of the retroactive cancellation of taxes held invalid) can the ECJ decide to make its decision apply prospectively or otherwise limit its application.

The flow of ECJ decisions on direct taxes has accelerated dramatically in the last five or six years, and

2007 was no exception. Following is a brief analysis of some of the most significant decisions issued in 2007 and their impact on Italian tax law.

## IV. 2007 ECJ Decisions on Direct Taxes

### A. Taxation of Outbound Dividends

#### 1. *Amurta* (C-399/05)

On November 8, 2007, the ECJ issued its decision in *Amurta*, which deals with member states imposing a withholding tax on outbound dividends to nonresident shareholders while exempting dividends to resident shareholders.<sup>2</sup>

The ruling in *Amurta* follows the ECJ's decision on *Denkavit* issued at the end of 2006. *Denkavit* dealt with intercompany dividends under the freedom of establishment of article 43 of the EC Treaty.<sup>3</sup> *Amurta* deals with portfolio dividends under the free movement of capital of article 56 of the EC Treaty. In both cases, the national tax laws under challenge have been struck down as incompatible with EU law.

The likely result is the disappearance of outbound dividend withholding tax in Europe.

**Facts and National Tax Rules.** *Amurta* S.G.P.S., a company with its registered office in Portugal, held 14 percent of the stock of Retailbox B.V., a Dutch resident company whose other shareholders were Soneatelecom B.V., another Dutch resident company, with 66 percent of the stock; Tafin S.G.P.S. and Persin S.G.P.S., both with their registered office in Portugal, with 14 percent and 6 percent of the stock. The three Portuguese shareholders were apparently unrelated.

On December 31, 2002, Retailbox B.V. paid dividends to its shareholders. The dividend paid to *Amurta* (and the other two Portuguese shareholders) was subject to 25 percent withholding tax under article 1 of the Dutch Dividend Tax Act, 1965 (DTA), reduced to 10 percent under the Netherlands-Portugal tax treaty.

The dividend paid to the domestic shareholder, Soneatelecom B.V. was exempt from withholding tax under article 4 of the DTA, which exempts from withholding tax all dividends paid to corporate

shareholders resident in the Netherlands or to PEs of foreign shareholders to which the dividend is attributable.

Article 13 of the Corporate Income Tax Act (CITA) provides that the exemption in article 4 applies only if the stock in the Dutch company is held by shareholders who are subject to Dutch corporate income tax (namely, companies resident in the Netherlands), or by foreign shareholders with a PE in the Netherlands to which the dividends are connected.

*Amurta* did not have a PE in the Netherlands to which the stock was effectively connected, and could not benefit from the exemption granted under article 4 of the DTA and article 13 of the CITA. Also, since it owned less than 25 percent of the stock of the Dutch company distributing the dividends, it was not eligible for the benefits of the parent-subsidiary directive (as enacted in the Netherlands with article 4a of the DTA).

Had *Amurta* been a Dutch resident company, or had it maintained a PE in the Netherlands to which the stock and the dividend could be attributed, it would have been exempt from Dutch dividend withholding tax.

Article 24 of the Netherlands-Portugal tax treaty provided that Portugal would grant a tax credit to offset Portuguese tax on the dividend income, subject to any limitations provided for under Portuguese law, for the amount of the Dutch withholding tax charged on the dividend.

It was not entirely clear whether Portugal actually granted a full credit for the Dutch withholding tax (even if it exceeded the amount of Portuguese tax on the dividends), as argued by the Netherlands, or exempted the dividend in the hands of the shareholder, with no credit for the foreign withholding tax, as argued by the taxpayer.

The Dutch court of first instance concluded that the different tax treatment of nonresident shareholders was justifiable to ensure the coherence of the national tax systems across Europe, in which dividend withholding taxes are common, and also because *Amurta* was not worse off economically than a Dutch taxpayer since it could benefit from a tax credit for the Dutch withholding in Portugal under the tax treaty.

The Court of Appeals in Amsterdam decided to refer the case to the ECJ and submitted the following questions:

- Is the Dutch tax treatment of outbound dividends compatible with the freedom of movement of capital established in articles 56 and 58 of the EC Treaty, considering that the Dutch dividend tax exemption included in article 4 of the DTA applies only to dividend distributions to companies that are subject to Dutch corporate income tax, or to a PE of foreign companies in the Netherlands to which the shares are attributable and to which

<sup>2</sup>For the judgment, see *Doc 2007-24955* or *2007 WTD 218-13*; for analysis, see Tom O'Shea, "ECJ Strikes Down Dutch Taxation of Dividends," *Tax Notes Int'l*, Jan. 14, 2008, p. 103, *Doc 2007-28346*, or *2007 WTD 10-8*.

<sup>3</sup>For the judgment, see *Doc 2006-24958* or *2006 WTD 241-13*; for analysis, see Tom O'Shea, "Dividend Taxation Post *Man-ninen*: Shifting Sands or Solid Foundations?" *Tax Notes Int'l*, Mar. 5, 2007, p. 887, *Doc 2007-3338*, or *2007 WTD 44-4*; Jérôme Delaurière, "Does *Denkavit* Signal the End of Withholding Tax?" *Tax Notes Int'l*, Jan. 29, 2007, p. 303, *Doc 2007-793*, or *2007 WTD 20-10*.

the participation exemption included in article 13 of the Dutch CITA, 1969 applies?

- In answering the first question, should it be taken into account that the country of residence of the foreign shareholder that is not eligible for the Dutch withholding tax exemption grants a full credit for the Dutch withholding tax?

**Advocate General's Opinion.** Advocate General Paolo Mengozzi issued his opinion in the case on June 7, 2007.<sup>4</sup>

He analyzed the applicable national tax law and observed that Dutch income tax law (article 4 of the DTA) exempted from withholding tax dividends distributed to resident shareholders (or to a Dutch PE of nonresident shareholders), who own at least 5 percent of the stock of the distributing Dutch company.

A similar exemption is granted (under article 4a of the DTA, which implements the parent-subsidiary directive) to foreign corporate shareholders resident in other EU member states who own at least 25 percent of the stock of the Dutch distributing company.

Mengozzi concluded that foreign shareholders owning more than 5 percent but less than 25 percent of the stock of a Dutch company were subject to a less favorable tax treatment than domestic shareholders owning the same amount of stock.

He then examined whether the different tax treatment could be regarded as a violation of the free movement of capital of article 56 of the EC Treaty, which depends on whether resident and nonresident taxpayers are in a comparable situation.

According to ECJ case law, a difference in tax treatment based on residence is not discriminatory since residence is indicative of a taxpayer's special link with its country of origin and usually justifies a different tax treatment (typically, residents are taxed on worldwide income while nonresidents are taxed only on income from sources within the host state).

However, if there is no objective difference between the two categories of taxpayers, a different tax treatment amounts to discrimination in violation of the EC Treaty.

Mengozzi referred to *Denkavit* (C-170/05) and *ACT Group Litigation* (C-374/04), both decided at the end of 2006, in which the Court held that:

once a Member State, unilaterally or by a convention, imposes a charge to income tax not only on resident shareholders, but also on non resident shareholders, in respect of dividends which they receive from a resident company, the position of

those non resident shareholders become comparable to that of resident shareholders.

In that case, by asserting its tax jurisdiction as the state in which the company making the distribution is established, the Netherlands exercises a power of taxation in relation to nonresident shareholders that is no different from that exercised in relation to resident shareholders, and if it decides to grant an exemption to resident shareholders to avoid double taxation or corporate profits, the Netherlands must extend the same benefit to nonresident shareholders since they suffer the same double taxation because of the exercise of that state's power of taxation over them.

Mengozzi said the Netherlands, which taxes nonresident shareholders on dividends paid by Dutch companies, should extend to nonresident shareholders the same kind of relief from double taxation it grants to resident shareholders, by exempting nonresident shareholders from withholding tax on dividends distributed by Dutch companies. In failing to do so, it violates the EC Treaty.

Mengozzi rejected the arguments advanced by the United Kingdom and Italy according to which the difference in the tax treatment of foreign shareholders is merely a consequence of the allocation of taxing powers between the Netherlands and Portugal, and it is justified by the need to preserve the cohesion of the Netherlands' tax system.

As to the first argument, Mengozzi observed that the discrimination is not the effect of a difference between the national tax systems of the two member states involved, but it is attributable solely to the Netherlands' tax legislation, which subjects nonresident shareholders to tax while denying them a tax advantage granted to resident shareholders.

As to the second argument, Mengozzi referred to the ECJ's test for the cohesion justification. Under this justification, for a discriminatory measure to be justified, there must be a direct link between a tax advantage on one side and an offsetting tax levy on the other, and the two must relate to the same tax and the same taxpayer. That test was not met in *Amurta* and therefore the cohesion argument failed.

Mengozzi then analyzed both the importance of a full credit granted under Portuguese domestic law and the effects of a tax credit granted under the bilateral income tax treaty between the Netherlands and Portugal.

He observed that it is not clear from the records whether *Amurta* would receive a tax credit in Portugal for the withholding tax paid to the Netherlands, and for what amount, or whether it would be exempt from tax on the dividend in Portugal and could not actually benefit from any credit for the Dutch withholding tax in its state of residence.

<sup>4</sup>For analysis, see Rudyard Bekker, "Dutch Treatment of Dividends Violates EC Treaty, AG Says," *Tax Notes Int'l*, June 25, 2007, p. 1287, *Doc 2007-14243*, or *2007 WTD 117-1*.

Nevertheless, Mengozzi observed that a member state cannot rely on the national tax legislation of another other member state to correct the discriminatory effects of its own tax law. Consequently, for the purposes of assessing the compatibility of the Netherlands' law on the taxation of outbound dividends with EU law, that the foreign taxpayer may be granted a credit under the internal laws of its own residence country (Portugal) for the withholding tax paid to the source state (the Netherlands) would be irrelevant.

In contrast, the discriminatory effects of a member state's national legislation can be eliminated under the application of a tax treaty entered into with the other member state.

According to Mengozzi, attaching relevance to a tax treaty allows a state to take into account the economic reality of a taxpayer's economic activities and the way in which the member states have complied with the fundamental freedoms by means of appropriate allocation of their taxing powers by assuming reciprocal commitments under a binding agreement.

In other words, when the credit or other tax measure which would offset a discriminatory tax imposed by a member state is not the result of a unilateral action of the other member state, but, rather, a contractual commitment bargained for by the two member states, when agreeing on the proper allocation of their respective taxing powers on cross-border activities of taxpayers resident in either state, the effects of the bargained-for tax treaty measure can be taken into account in assessing the validity of either state's domestic tax law on the face of the EC Treaty.

For the discrimination to be eliminated, however, the global treatment to which the taxpayer is subjected as a result of the application of a member state's domestic tax laws in combination with the relevant tax treaty between that state and the taxpayer's state of residence must not be worse off than the treatment to which the residents of the former state are subject to for the same item of income, and the state that imposes a discriminatory tax is responsible to make sure that the discriminatory treatment stemming from its own law is neutralized as a result of the proper application of the tax treaty by the other member state.

For the discriminatory effects of the Netherlands' dividend withholding tax to be corrected, the taxpayer should receive credit in Portugal under the Netherlands-Portugal tax treaty for the entire amount of withholding tax levied on the dividend in the Netherlands.

The Netherlands-Portugal tax treaty does not provide for a full credit but for an ordinary credit not exceeding the amount of the Portuguese corporate income tax on the dividend income. Therefore, according to Mengozzi, the discrimination was not eliminated and Dutch law was incompatible with EU law.

**ECJ Decision.** The ECJ issued its decision on November 8, 2007.

*Parent-Subsidiary Directive.* The Court first discussed the role of the parent-subsidiary directive. Article 5(1) of the directive provided for an exemption from withholding tax only for intercompany dividends (dividends paid to corporate shareholders who own at least 25 percent of the stock of the distributing company).<sup>5</sup> Amurta owned only 14 percent of the stock; therefore, it was not eligible for the exemption under the directive. The Netherlands and Italy argued that for matters that fall outside the scope of the directive and those that are below the threshold for the exemption from withholding tax provided for therein, member states are free to impose any withholding taxes they deem appropriate, and this in itself cannot be regarded as a violation of EU law.

The Court distinguished the scope of the directive and the EC Treaty fundamental freedoms. The parent-subsidiary directive is designed to eliminate the double taxation of corporate profits distributed as intercompany dividends in the EU.

The fundamental freedoms intend to guarantee the free movement of workers, capital, and services and the establishment of business activities within the EU and to prevent the member states from imposing discriminatory tax burdens on them.

Therefore, the Court agreed that outside the scope of the parent-subsidiary directive, the member states are free to choose the best method to eliminate the double taxation of corporate profits. However, this does not mean they can impose taxes that contravene the freedom of movement guaranteed by the EC Treaty.<sup>6</sup>

*Discrimination.* The Court then turned to the discrimination issue and agreed with Mengozzi by holding that nonresident taxpayers that are subject to tax on the dividend are in a comparable situation as resident taxpayers subject to tax in their member state of residence, and concluded that the different tax treatment provided to similarly situated taxpayers under the Netherlands' tax law constitutes a violation of the free movement of capital granted under the EC Treaty.<sup>7</sup>

On this issue, the German, U.K., and Italian governments referred to the generally accepted principles of international tax law according to which resident and nonresident taxpayers are not similarly situated, because the former are taxed in their residence state on their worldwide income, while the latter are taxed only

<sup>5</sup>The minimum ownership threshold is 15 percent for the years 2007-2008 and will be reduced to 10 percent from 2009.

<sup>6</sup>*Amurta*, para. 24.

<sup>7</sup>*Id.*, para. 38.

on income from sources within that state, and it is up to the state of residence to eliminate double taxation of income.

The ECJ dismissed that argument by referring to its precedents in *Denkavit* and *Test Claimants in the ACT Group Litigation*; when a member state decides to impose an income tax on dividends paid to nonresident shareholders, the position of those nonresident shareholders becomes comparable with that of resident shareholders.

According to the Court, the risk of (economic) double taxation on dividend income originates solely from the fact that the Netherlands purports to exercise its taxing power and subject the dividend income of nonresident shareholders to withholding tax in the Netherlands (regardless of any taxation of the same income that may be imposed in another member state), and the Netherlands, when choosing the methods to avoid double taxation of income under its own tax law, must make sure that it treats nonresident and resident shareholders alike to comply with the EC Treaty's free movement of capital provision. In failing to do so and granting the exemption to resident shareholders only, it violated the EC Treaty.<sup>8</sup>

*Justifications: Fiscal Cohesion and Allocation of Taxing Rights.* The ECJ discussed the possible justifications of the Dutch discriminatory tax.

The Netherlands invoked the fiscal cohesion of its tax system.<sup>9</sup> It argued that the withholding tax exemption of article 4 of the DTA is a complement of the shareholding exemption of article 13 of the CITA, in the sense that without the exemption from withholding the shareholding exemption would be partially (although only temporarily) negated, since until the dividend tax is set off against the corporate income tax, income that is exempt from tax would be taxed. According to this argument, although the corporate tax and dividend tax are two separate taxes, the dividend withholding tax is nothing more than an anticipated tax that can be set off in full against the corporate tax; the two go hand in hand to ensure the coherence of the tax system.

<sup>8</sup>*Id.*, paras. 39-40.

<sup>9</sup>The ECJ accepted fiscal cohesion as justification of restrictions to fundamental freedoms in *Bachman* (C-204/90) and *Commission v. Belgium* (C-300/90), both decided on January 28, 1992, on the basis of the existence of a direct link between a tax restriction and offsetting tax benefit concerning the same tax and the same taxpayer. In both cases, Belgian residents could not deduct foreign insurance premiums but were not taxed on foreign insurance awards. The Court found a direct link between the tax restriction and the tax benefit and held that the restriction was justified by the need to maintain the coherence of the national tax system. The Court rejected tax cohesion as a valid justification of restrictive national laws in the absence of such direct link concerning the same taxpayer in *Danner* (C-136/00), *Verkooijen* (C-35/98), and *Wielockz* (C-80/94).

The ECJ rejected this argument and observed that, even if it were true that the dividend withholding tax exemption and the shareholdings exemption are intrinsically linked, the Netherlands has failed to show a direct link between the tax advantage of the exemption from withholding and a corresponding tax levy on the same taxpayer. The Netherlands acknowledged that there is no tax levy offsetting the tax exemption and this is only a matter of administrative simplification, which cannot justify a restriction.<sup>10</sup>

Since profits distributed both to resident and nonresident shareholders have been subject to corporate tax at the level of the distributing company, the Netherlands has not shown how the cohesion of its tax system would be jeopardized if the exemption were granted also to nonresident shareholders, who are exactly in the same position as the resident shareholder.<sup>11</sup>

The United Kingdom argued that the cohesion of the tax system should be assessed at a cross-border level, by looking at the relevant tax treaty between the two states, according to which the Netherlands as the source state can charge a withholding on the dividend, and Portugal as the residence state must grant a tax credit for the elimination of double taxation. The ECJ argued that the application of the Dutch withholding tax is not made conditional on the existence of a tax treaty that authorizes it and that the cohesion of the national tax system under that treaty is not part of the reference.<sup>12</sup>

The United Kingdom also invoked the allocation of taxing powers between the two member states as expressed in the relevant tax treaty. The ECJ dismissed this argument by observing that once the Netherlands has decided not to charge the tax on dividends on resident shareholders, it cannot invoke the allocation of taxing powers to justify the application of that same tax on shareholders of the other member states.

*Foreign Tax Credit for Withholding Tax.* Finally, the Court examined the foreign tax credit issue and affirmed a principle established in its recent case law:<sup>13</sup> While a member state cannot rely on another member state's unilateral concession of a tax benefit under its own internal laws to rectify the discrimination created by the first member state's law, a double tax treaty signed between two member states is part of the legal system of a member state and the legal background

<sup>10</sup>*Amurta*, paras. 49-50.

<sup>11</sup>*Id.*, para. 51.

<sup>12</sup>In *Wielockz*, the Court rejected the fiscal cohesion defense in a situation in which the offsetting exemption was granted under the treaty as opposed to domestic law.

<sup>13</sup>*Test Claimants in Class IV of ACT Group Litigation*, para. 71; *Denkavit*, para. 45; and *Test Claimants in the Thin Cap Group Litigation*, para. 54.

against which the compatibility of the member state's national tax law with EU law must be examined.

Therefore, a member state can succeed in ensuring compliance with EU law through the conclusion of an income tax treaty with another member state.<sup>14</sup>

In the case at hand, if it were proved that Portugal granted a full credit for the dividend withholding tax charged in the Netherlands and ultimately *Amurta* would not be worse off than a Dutch resident shareholder for taxation of dividends, the Netherlands withholding tax could withstand scrutiny under EU law.

However, it is up to the national court to determine whether account should be taken in the main proceedings of any income tax treaty between the two member states and whether the application of that treaty would neutralize the effects of the restriction on the free movement of capital.

**Relevance of *Amurta*.** The decision in *Amurta* follows the December 14, 2006, ECJ decision in *Denkavit* (C-170/05).

In *Denkavit*, a wholly owned French subsidiary distributed dividends to its Dutch parent, on which France imposed a withholding tax at the reduced treaty rate of 5 percent. In the years in which the dividends were distributed, (1987-1989) the parent-subsidiary directive was not in place. France did not charge any withholding tax on dividends paid to resident corporate shareholders.

Although the France-Netherlands tax treaty provided for a tax credit to be granted in the Netherlands for taxes withheld at source in France, the Netherlands exempted the Dutch parent from corporate tax on the dividend income and granted no credit for the French withholding tax. The Dutch parent challenged the validity of the French tax charged on nonresident shareholders only, as a violation of the freedom of establishment in article 43 of the EC Treaty.

The ECJ ruled in favor of the Dutch parent on the basis of reasons similar to those set forth in *Amurta*. In *Denkavit*, the income tax treaty could not rectify the discrimination because the dividend income was exempt in the Netherlands and no foreign tax credit for the French tax was granted in the Netherlands under the treaty.

*Amurta*, however, goes further and constitutes an important development toward the elimination of outbound dividend withholding taxes in the EU. There are at least two major implications.

First, an outbound dividend withholding tax charged on nonresident shareholders while the resident shareholders are exempt is illegal even if the nonresident shareholders are not eligible for the exemption granted

under the parent-subsidiary directive. The tax constitutes a direct violation of the EC Treaty. This means that the EC Treaty may trump the directive and can extend to taxpayers greater relief than what is provided for in a tax directive regulating the same matter. If a taxpayer is not entitled to the benefits of the directive because it fails to meet any of the requirements for the exemption, he might still be able to claim the exemption granted to residents directly under the EC Treaty.

## ***Amurta* constitutes an important development toward the elimination of outbound dividend withholding taxes in the EU.**

Second, *Amurta* enforces the free movement of capital provision of article 56 of the EC Treaty, which applies to third countries. Portfolio investors owning portfolio stock in an EU company can claim the exemption from withholding tax if the exemption is granted to resident shareholders, whether or not the investors reside within the EU. In contrast, relief under article 43 can be granted only to taxpayers established in the EU. This raises the issue of which freedom applies when the third-country shareholders own substantial shareholdings.

The ECJ has held that the application of the freedoms depends on the exact objective of the national rules. If the national rules are designed to apply only to situations in which the taxpayer owns a substantial shareholding that gives him definite influence over a company in another member state, then only the freedom of establishment applies to test the validity of national rules under EU law. If the national rules apply to both direct and portfolio investments regardless of the size of the shareholding, the validity of the rules can be tested separately under each of the two freedoms.

Finally, the holding in *Amurta* can extend to individual portfolio shareholders.

While *Amurta* was pending, the Netherlands repealed its rules with effect from January 1, 2007. However, *Amurta* is retroactive and any withholding taxes paid before that date can be claimed as a refund (if the deadline for the refund under the Netherlands' law has not expired).

**Implications on Italian Taxation of Outbound Dividends.** Under Italy's domestic tax law, Italian-source dividends paid to nonresident shareholders are subject to a 27 percent final withholding tax. The withholding

<sup>14</sup>*Amurta*, para. 80.

tax is reduced under tax treaties, eliminated under the parent-subsidiary directive, or partially refunded on account of any tax on the dividend paid by the recipient to its country or residence (up to a maximum of four-ninths, so that the withholding tax can be reduced to not less than 15 percent), on submission of sufficient evidence of payment of the foreign tax on the dividend.

Dividends paid to resident portfolio shareholders are subject to 12.5 percent gross basis withholding tax. Dividends paid to resident shareholders on nonportfolio stock or stock held in a trade or business are exempt for 60 percent of the amount and taxable for 40 percent of the amount on a net basis at graduated rates.

Dividends paid to resident companies are exempt for 95 percent of the amount and taxable for 5 percent of the amount at the corporate tax rate of 27.5 percent (equal to an effective tax rate of 1.375 percent). The 95 percent exemption is granted regardless of the amount of stock owned in the company that distributes the dividends.

## Italy's new rules fail to put Italian law in compliance with EU law for dividends distributed out of earnings and profits accrued before January 1, 2008.

As a result of the ECJ decision in *Denkavit*, Italy changed its tax law with the Budget Law for 2008. Under the new rules, dividends paid by Italian companies to companies resident in an EU or EEA member state and liable for the corporate tax in that state are subject to a withholding tax of 1.375 percent. No requirements apply for the reduced rate, except that the recipient must be a company resident in an EU or EEA state and subject to corporate income tax in that state.

The new tax equates the treatment of domestic and outbound dividends to corporate shareholders in Italy and the EU or EEA. The new rules apply to dividends distributed out of earnings and profits accruing in tax years beginning on or after January 1, 2008.

In view of the general retroactive effect of *Denkavit* and *Amurta*, Italy's new rules are not sufficient to put Italian law in compliance with EU law for dividends distributed out of earnings and profits accrued before January 1, 2008. Taxpayers can claim a refund for withholdings taxes paid out of earnings and profits accrued in tax years beginning on or before January 1,

2008, provided that they file a refund claim within 48 months after the payment of the tax.

The new rules do not eliminate the different tax treatment of dividends paid to individual investors. Individual shareholders resident in an EU member state are still subject to a 27 percent withholding tax (reduced to 15 percent under tax treaties), as opposed to the 12.5 percent tax applicable to Italian individual shareholders.

Finally, the new rules do not eliminate the different tax treatment of dividends paid to third-country shareholders.

Under *Amurta*, shareholders resident in a non-EU country and owning portfolio stock in Italian companies can claim the same tax on the dividends that applies to dividends paid to Italian companies (1.375 percent) or to Italian individual shareholders (12.5 percent).

### B. Cross-Border Losses

In 2007 the ECJ issued two important decisions on matters of cross-border group relief, after its landmark decision in *Marks & Spencer* (C-446/03) issued in December 2005.<sup>15</sup>

#### 1. Rewe Zentralfinanz

On March 29, 2007, the ECJ issued its ruling in *Rewe Zentralfinanz* (C-347/04),<sup>16</sup> in which it held that German corporate tax rules that restrict the ability of a German parent company to take a deduction against its income taxable in Germany for the amount of losses because of write-downs on its stock in foreign subsidiaries, while no similar restrictions would apply to the deduction of write-downs for stock of domestic subsidiaries, violate the freedom of establishment of article 43 of the EC Treaty and is not justified by the need to preserve the allocation of taxing rights between member states, avoid the double use of losses, or combat tax avoidance.

The case distinguished *Marks & Spencer* and provided additional insight on the issue of compatibility of EU law and national legislations regarding tax consolidation or group relief.

**Facts.** Rewe Zentralfinanz eG was the successor company by merger of ITS, a German limited liability company that conducted business in the tourism sector.

ITS owned stock in U.K. and Spanish subsidiaries through two Dutch holding companies. In 1993 and

<sup>15</sup>For the judgment, see *Doc 2005-25015* or *2005 WTD 239-16*.

<sup>16</sup>For the judgment, see *2007 WTD 62-13*; for analysis, see Tom O'Shea, "Further Thoughts on *Rewe Zentralfinanz*," *Tax Notes Int'l*, Apr. 9, 2007, p. 134, *Doc 2007-8720*, or *2007 WTD 69-6*; and Jorg-Dietrich Kramer, "German Tax Provisions at Odds with EC Treaty," *Tax Notes Int'l*, June 11, 2007, p. 1108, *Doc 2007-13554*, or *2007 WTD 110-4*.

1994, ITS made partial write-downs to the book value of its shares in the upper-tier Dutch holding companies, as a result of operating losses incurred by its U.K. and Spanish operating subsidiaries, and to the value of receivables from its U.K. and Spanish subsidiaries.

Rewe Zentralfinanz eG claimed a deduction for the write-downs of stock and receivables to offset its positive income taxable in Germany, for an amount in excess of €23 million. The deduction was disallowed under a provision of the German income tax code that did not permit deduction for write-downs by German parent companies regarding stock of foreign subsidiaries, although such write-downs were permitted for stock of domestic subsidiaries.

According to the provision, losses from write-downs of shares in an entity that is not resident in Germany could only be offset against positive income of the same type from the same country. No such restriction would have applied if the same losses had been claimed for stock in German subsidiaries. An active business exception to the rules could not apply because tourism business did not qualify.

**ECJ Ruling.** The ECJ argued that the freedom of establishment means that the residence state cannot treat resident taxpayers who invest or do business in another member state less favorably than resident taxpayers who invest or do business only domestically. According to the ECJ, this is a case of home state or state of origin discrimination, and the proper comparison is the one between German parent companies with foreign subsidiaries and German parent companies with domestic subsidiaries.<sup>17</sup>

German tax law granted the loss relief for write-downs for stock owned in domestic subsidiaries, while it denied the same relief for write-downs for stock of foreign subsidiaries, limiting the tax advantage to purely domestic situations.

The tested taxpayer under this approach is the German parent company. A German parent company that exercises its freedom of establishment by doing business through foreign subsidiaries in other member states was disadvantaged under German tax law, because German tax law treated a German parent company that operated through a subsidiary in Germany more favorably than a German parent company that operated through a subsidiary in another member state. The former can write down the stock of the domestic subsidiary and get a deduction for the stock loss against its taxable income, while the latter cannot.

The German parent companies were in a comparable situation because the losses were suffered by the

German parent company in both cases, and the profits of the domestic or foreign subsidiaries were not taxable in the hands of the German parent company. The different tax treatment of such comparable situations was a restriction of the freedom of establishment in violation of the EC Treaty.

**Justifications.** Germany argued that the proper allocation of taxing power and the tax base between member states justified the restriction on the freedom of establishment. Germany did not tax the profits of the foreign subsidiary in Germany, so it should not be requested to relieve its losses. Rather, the foreign host country should take into account the losses of the foreign subsidiary because it is that country that taxes the subsidiary's profits.

The Court rejected this argument, noting that the losses under consideration are losses of the German parent, and a different tax treatment of German resident parent companies could not be justified merely because they have decided to carry out a business activity in another member state in which Germany could not exercise its taxing power. Clearly, Germany compared the tax treatment of foreign versus domestic subsidiaries, while the ECJ focused on the tax treatment of German parent companies with domestic and foreign subsidiaries.

Germany also argued that its tax rules were necessary to avoid a double dip, that is, that the same losses could be used twice (once to reduce the foreign subsidiary's taxable income in the host state and then to reduce the German parent company's taxable income in the home state, Germany).

The Court acknowledged that member states must be able to enact rules that prevent the risk of tax losses being used twice, and that is a possible justification of restrictions to the fundamental freedoms and referred to its previous decision in *Marks & Spencer*.

However, the Court responded that the case at hand only concerned the parent company taking a deduction for a loss on the stock of its foreign subsidiary, in its home state, and not the subsidiary claiming its own losses in two different countries. This was a separate tax treatment in the parent's home state of losses, which were related to the writing down of the value of the stock of the parent resident in that state, and not of the losses suffered by the subsidiaries in the host state.

The Court distinguished *Marks & Spencer*, in which the subsidiaries surrendered their losses to the U.K. parent company so that they could be used to offset the parent's income in the United Kingdom under U.K. law.

The Court also observed that in the case of a German parent-German subsidiary situation, the parent is permitted to deduct write-downs in the value of the stock of the subsidiary, whereas the subsidiary can still use its own losses in computing its taxable income in

<sup>17</sup>For analysis, see Tom O'Shea, "From Avoir Fiscal to *Marks & Spencer*," *Tax Notes Int'l*, May 15, 2006, p. 587, *Doc 2006-3391*, or 2006 *WTD 95-10*.

Germany. Therefore, the alleged need to prevent the double use of losses cannot be a valid justification of the discriminatory rules.

## The decision in *Rewe* confirms the Court's approach in *Marks & Spencer* and *Cadbury Schweppes*.

The next argument was that the rules in question were justified by the need to avoid tax evasion schemes based on the creation or artificial losses to be used to reduce domestic taxable income through write-downs in value of stock of foreign subsidiaries. The Court rejected this argument on the basis that the rules were overbroad and failed to meet the proportionality test. The rules were not limited to “wholly artificial arrangements” designed to circumvent German tax law, but applied generally to any situations in which subsidiaries are established, for any reason, outside of Germany and engaged in some disqualified activities.

The active business exception, which carves out activities perceived as abusive, could not help sustain the rules, because it did not establish any standards to distinguish between legitimate business transactions and artificial tax abusive arrangements.

Germany also argued the need for fiscal supervision, but that was dismissed by the Court by a reference to the directive on mutual assistance and exchange of information by the competent authorities of member states.

Germany's final argument was that the rules were justified by the need to maintain the fiscal coherence of the tax system and to respect the principle of territoriality.

Germany argued that dividends from Dutch subsidiaries to German parent companies are exempt from tax in Germany under the Germany-Netherlands tax treaty, so Germany should not be required to take into account a loss of the Dutch subsidiary, either directly or indirectly by way of a deduction for the write-downs of the stock.

The Court acknowledged that the coherence of tax systems can be a possible justification to the restriction of the freedom of establishment, but it requires a direct link between the tax advantage and an offsetting tax levy based on its settled case law.

In the case at hand, this link is missing. Indeed, a German parent company with a German subsidiary is entitled to both an immediate deduction for losses from a write-down of stock of its domestic subsidiary

and an exemption of dividends from the domestic subsidiary; the deduction of write-downs would have been allowed if the foreign subsidiary had been engaged in an active business other than tourism. Therefore, Germany had failed to establish a direct link between the tax advantage of the exemption of dividends and the denial of the loss deduction.<sup>18</sup>

Germany also observed under the fiscal coherence argument that the German parent's capital gains from the sale of stock of foreign subsidiaries are tax exempt, and therefore losses from a write down of a foreign subsidiary's stock should be disallowed. The Court replied that the disallowance of loss had an immediate effect; therefore, the exemption of possible future gains if the subsidiary became profitable was not a valid consideration for the immediate disallowance of the loss on the stock based on fiscal cohesion.

The decision in *Rewe* confirms the Court's approach in *Marks & Spencer* and *Cadbury Schweppes*, in which the Court is prepared to justify national rules that limit the freedom of establishment based on the need for a proper allocation of taxing rights and to combat tax avoidance schemes or the double use of losses at the cross-border level, provided that they are not overbroad and set clear standards to target only clearly abusive situations and avoid excessive hurdles to the freedom of doing business within the EU.<sup>19</sup>

The specific aspects of German law prevented the Court from applying *Marks & Spencer* to the particular case.

### 2. *Oy AA*

On July 18, 2007, the ECJ issued its judgment in the Finnish case *Oy AA* (C-231/05). The case concerned the compatibility of Finnish rules on intragroup financial transfers with EU law. It develops further the line of decisions following the ECJ ruling in *Marks & Spencer* and represents a significant victory for the revenue authorities.

**Facts.** Under Finnish law, companies can transfer their profits to other companies belonging to the same tax group. Group contributions are taxable income for the recipient company and a tax deduction for the contributing company, provided that specific criteria are met. In this way, profits and losses can be consolidated within the same tax group. One condition for the application of the group relief rules is that the contributing company and the recipient company are Finnish resident companies (both subject to corporate tax in Finland). As a result, under Finnish law consolidation rules group relief is allowed only at the domestic level.

<sup>18</sup>*Rewe Zentralfinanz*, para. 63.

<sup>19</sup>The ECJ used the wholly artificial arrangement test for the first time in *ICI* (C-264/94), decided on July 16, 1998 (of which *Marks & Spencer* is the direct progeny).

In *Oy AA*, a Finnish subsidiary made a contribution of its profits to a U.K. parent. The U.K. parent had net operating losses that would offset the profit contribution from its Finnish subsidiary. The Finnish subsidiary claimed a deduction in Finland for the profits contribution made to the U.K. parent. The deduction was disallowed because the parent was not a Finnish resident company. The Finnish subsidiary challenged the denial of the deduction and the case was referred to the ECJ.

**Discrimination.** The ECJ analyzed the case under the freedom of establishment provision of article 43 of the EC Treaty and held that the Finnish rules violated the freedom of establishment because they provided for a different tax treatment of Finnish companies depending on the residency of their parents, and the rules treated Finnish subsidiaries with a parent company resident in another member state less favorably than Finnish subsidiaries with a Finnish parent company. As a result, the freedom of EU parent companies to establish their business in Finland and operate there through Finnish subsidiaries was impaired.

**Justification.** The ECJ then analyzed the existence of a possible justification to the restriction under two arguments: the need to safeguard a balanced allocation of the taxing power between member states, and the need to prevent tax avoidance. The ECJ concluded that the restriction was justified on the basis of both grounds referred to above.

*Allocation of Taxing Rights.* With reference to the need to preserve the allocation of taxing rights between member states, the ECJ observed that allowing a subsidiary's deduction for cross-border intragroup transfer of profits without limitations would undermine a member state's power to tax income arising from activities carried out by the subsidiary within its own territory, because then a group of companies could freely choose the member state in which their subsidiary's profits would be taxed. In such case, a subsidiary could transfer its profits at its own option to its parent company or another affiliate resident in another member state and not pay tax on its profits in its member state of residence.

The ECJ stressed that the need to safeguard the power to tax could not justify "a Member State systematically refusing to grant a tax advantage to a resident subsidiary, on the ground that the income of the parent company, having its establishment in another Member State, is not capable of being taxed in the first Member State."

However, the Court noted that this argument applies and the restriction is feasible when tax rules are "designed to prevent conduct capable of jeopardizing the right of Member States to exercise their taxing powers in relation to activities carried out in their own territories."

The Court referred to its decision in *Marks & Spencer*, in which it held that companies could be denied the

right to freely elect to have their losses taken into account in their member state of establishment or in another member state because the right "would seriously undermine a balanced allocation of the power to impose taxes between Member States."

*Prevention of Tax Avoidance.* The Court observed that if cross-border intragroup transfers were allowed without limitations, a group of companies could choose to set up artificial entities in low tax countries or countries in which the transfers of profits would not be taxed at all, and thereby avoid taxation on their profits anywhere.

The Court argued that the possibility to make intragroup transfers of profits carried "the risk that, by means of purely artificial arrangements, income transfer may be organized within a group of companies towards companies established in Member States applying the lowest rates of taxation or in Member States in which such income is not taxed." Therefore, limitation to deduction of intragroup financial transfers designed to prevent similar practices are justified.

*Proportionality.* The Court then examined the proportionality issue.

The Court observed that even if the Finnish rules "were not specifically designed to exclude from the tax advantage . . . purely artificial arrangements, devoid of economic reality, created with the aim of escaping the tax normally due on the profits generated by activities carried out on national territory," those rules were nonetheless proportionate "to the objectives pursued, taken as a whole."

The Court refused to elaborate further on the wholly artificial arrangement test it had enforced in *Cadbury Schweppes* (C-196/04),<sup>20</sup> and it confirmed the validity of Finnish rules without any further discussion on this issue.

The Court referred to the wholly artificial arrangement test in various parts of the decision when discussing the possible justification to the restriction, but considered that both the need to combat tax avoidance and the proper allocation of taxing rights provided sufficient justification to sustain the challenged rules.

*Marks & Spencer Exceptions.* Also, the Court did not discuss the possible application of the last resort exception it used in its decision in *Marks & Spencer*.

In *Marks & Spencer*, the ECJ held that the U.K. group relief rules that allowed a U.K. parent to offset its income with the losses of a U.K. subsidiary but not those of a foreign subsidiary did not violate the freedom of establishment because of the need to safeguard the proper allocation of taxing rights and to prevent tax avoidance.

<sup>20</sup>For the judgment, see *Doc 2006-19082* or *2006 WTD 177-8*.

However, it put a limit on the justification and observed that if the foreign subsidiary has exhausted all the possibilities of claiming the losses in its member state of residence, and there are no possibilities of obtaining future relief for such losses in that state (either by the subsidiary or any acquiring company), then the restriction to the use of the losses by the parent in the home member state would no longer be justified.

## Oy AA can be considered a huge victory for the government and a significant loss for the taxpayer.

The ECJ did not elaborate on the limitation to the tax avoidance justification of the restrictive rules because the Finnish regime did not concern the transfer of losses from a loss-making subsidiary to a profitable parent, but the transfer of profits from a profitable subsidiary to a loss-making parent (actually, the flip side of *Marks & Spencer*).

The ECJ held that the justification applies even when the contribution is taxable income in the recipient's member state, the recipient is loss making, and there is no possibility to transfer its losses to another company or the need for a group contribution if justified by financial nontax reasons.

In general, *Oy AA* can be considered a huge victory for the government and a significant loss for the taxpayer. The Court has been generous in applying the tax avoidance justification to sustain the validity of the restriction imposed by Finnish national rules, did not elaborate on the wholly artificial arrangement test and last resort limitation to the tax avoidance justification, and directly rejected the taxpayer's claim.

The case would seem to confirm that the Court might be more willing to accept a government's restrictions on the fundamental freedoms as a means to stop tax abuse.

**Cross-Border Loss Relief Under Italian Law and the Impact of EU Law Tax Consolidation.** Consolidation is one way to transfer income or losses in a group under Italian tax law.

Italy's tax consolidation rules were enacted in 2004. Tax code sections 117 through 129 deal with domestic tax consolidation (Italian parent-Italian subsidiary), and tax code sections 130 through 142 deal with worldwide tax consolidation. Income or losses of foreign subsidiaries can be imported under the worldwide consolidation rules.

The two regimes differ in some material respects. As a general proposition, domestic tax consolidation is easier and triggers a more favorable tax treatment than worldwide tax consolidation.

*Domestic Consolidation.* Domestic tax consolidation is allowed for Italian parent companies that control Italian subsidiaries. For this purpose, the term "control" requires ownership of more than 50 percent of the stock (by value and profits interest) and more than 50 percent of voting shares or sufficient voting power to exercise a dominant influence on a shareholders' meeting that elects the company's directors. Stock owned through a company that is controlled under the above tests is attributed (pro rata) to the parent.

Tax consolidation is elective, and taxpayers can choose the subsidiaries they want to consolidate (there is no "all or nothing" rule).

The parent can be a resident corporation or a foreign corporation if it is resident in a state having an income tax treaty with Italy, carries on a trade or business through a PE in Italy, and owns the stock of its Italian subsidiary through its Italian PE.

The election is binding for three years and is not revocable. Each member of the consolidated group must compute its own taxable income or loss, file an informative income tax return (without computing the tax due), and pass on the return with all relevant documentation to the parent for computation of the group's income and taxes.

The full amount of taxable income, losses, credits, and loss-credit carryovers reported by the members of the group are amalgamated and offset at the level of the parent; the parent computes the net taxable income of the group, files the group's consolidated income tax return, and pays the group's income tax due or carries over the group's net loss to the next taxable year. The loss can be allocated back to the members that generated it, pro rata or in full.

Preconsolidation losses are ring fenced and can be used only by the members of the group that generated them in computing their own taxable income or loss for the year to consolidate at the level of the parent. The parent can use credits for excess taxes paid by the members of the group before the consolidation.

Intragroup dividends and transfer of assets are a taxable transaction.

*Worldwide Consolidation.* The access to worldwide consolidation is subject to much stricter requirements, and the tax treatment of worldwide consolidated groups is less favorable compared with domestic consolidation.

A parent can consolidate only if it is a publicly traded company or a company controlled by the state or by individual resident shareholders who do not control other resident or nonresident companies. The Italian parent and its foreign subsidiaries must have their

financial statements audited by external auditors, and the foreign subsidiaries must file an undertaking that they will provide to the Italian parent all necessary information and assistance concerning the computation of their taxable income or losses (to enable the parent to carry out its obligations under the consolidation rules). Also, a ruling must be obtained from the tax administration confirming that all requirements for consolidation are met. The election must include all foreign subsidiaries.

Income and losses of consolidated foreign subsidiaries are aggregated pro rata and not in full. The election is binding for five tax years (instead of three). The consolidating parent cannot join another domestic consolidated group.

Income and losses of foreign subsidiaries can be consolidated provided that the foreign subsidiaries' book and tax accounts are audited and certified by independent auditors. In case of an early exit from consolidation, foreign subsidiaries' losses that were offset during consolidation are recaptured and subject to tax in Italy.

*Compatibility of Italy's Tax Consolidation Rules With EU Law.* Italy's domestic and worldwide consolidation regimes are subject to different tax treatment that could constitute a violation of EU law.

Unlike an Italian parent company, a parent company resident in another member state cannot consolidate its Italian affiliates (unless it carries on a trade or business in Italy through a PE and owns the stock of the Italian companies through its Italian PE). From another perspective, Italian subsidiaries of an Italian parent company are treated more favorably than the Italian subsidiaries with a foreign parent company, because they can more easily be taxed on a consolidated basis with offset of profits and losses within the group.

An Italian parent company can consolidate its Italian subsidiaries but cannot consolidate its subsidiaries resident in other member states, unless the more severe requirements for worldwide consolidation are met (that is, the parent is publicly traded or controlled by the Italian state or individual resident shareholders who do not control other companies). As a result, Italian groups with foreign subsidiaries in other EU member states are subject to a less favorable tax treatment than Italian parents with domestic subsidiaries.

Even if an Italian parent company qualifies for worldwide consolidation of subsidiaries in other member states, consolidation is more difficult and subject to stricter conditions (for example, external audits of financial accounts, the all-or-nothing rule, the advance ruling requirement, or the loss recapture rule), and the resulting tax treatment that can be achieved is less favorable than that allowed under domestic consolidation rules.

These differences in each specific case can raise issues as to the compatibility of Italian worldwide tax consolidation rules with EU law.

**Election for Fiscal Transparency.** In 2004 Italy enacted its check-the-box rules, which also permit consolidation of profits and losses.

Under those rules, an Italian company owning stock of another Italian company (no more than 50 percent and not less than 10 percent by vote and profit share) can check the box on the Italian subsidiary and treat it as a fiscally transparent entity (partnership). Profits and losses of the subsidiary flow through to and are taxed in the hands of the shareholder.

## Italy's domestic and worldwide consolidation regimes are subject to different tax treatment that could constitute a violation of EU law.

The election for fiscal transparency is not available for foreign subsidiaries. All foreign entities, regardless of how they are classified and taxed under foreign law, are treated as separate entities for Italian tax purposes. Italian companies cannot consolidate profits and losses of foreign entities through Italian fiscal transparency rules.

As a consequence, Italian parent companies that own stock of Italian subsidiaries receive a better overall tax treatment, to the extent that they consolidate their profits and losses with the profits and losses of their Italian subsidiaries under Italian fiscal transparency rules, compared with Italian parent companies owning stock of subsidiaries in other EU member states, which cannot use foreign subsidiaries' losses to offset their Italian profits.

The disadvantage is especially evident for start-up ventures that generate losses in the initial years of operation. To import foreign losses, Italian companies would have to operate their foreign businesses in branch form at the cost of personal liability for the foreign business debts.

These differences in access to Italian fiscal transparency might constitute a violation of the freedom of establishment in other EU member states or, in case of noncontrolling shareholdings, the freedom of movement of capital.

Foreign investors into Italy are eligible to elect for Italian fiscal transparency only when there would be no withholding tax on profits distributions from the Italian company, had the Italian company not checked

the box. This is true only for foreign companies resident in an EU member state qualifying for the withholding tax exemption under the parent-subsidiary directive. This requires that the foreign company own at least 15 percent of the stock of the Italian company. Other companies resident in an EU member state that do not meet the requirements for the exemption under the directive cannot elect for fiscal transparency. To the extent that this precludes a more favorable tax treatment for their Italian investments under Italian law, Italian tax transparency rules may be considered incompatible with EU law.

### C. Thin Cap Rules, Tax Avoidance Justification, and the Wholly Artificial Arrangement Test

#### 1. Test Claimants in the Thin Cap Group Litigation

In *Test Claimants in the Thin Cap Group Litigation (Thin Cap GLO, C-524/04)*,<sup>21</sup> decided on March 13, 2007, the ECJ ruled on the validity of U.K. thin capitalization rules under the tax avoidance justification and confirmed the wholly artificial arrangement test applied in *Lankhorst-Hohorst (C-324/00)*.<sup>22</sup>

The issue was whether the U.K. thin cap rules as applied before April 1, 2004, were compatible with EU law. Until 2004, U.K. thin cap rules applied only to intragroup outbound interest, and therefore discriminated between interest paid to domestic related lenders (which were freely deductible by the U.K. borrower) and to foreign related lenders (which were recharacterized as dividends and were not deductible by the U.K. borrower). These rules were amended several times to make them compatible with the EC Treaty. After 1995 the U.K. rules applied only to interest exceeding arm's length, and from 1998 to 2004 were made part of the general transfer pricing rules. After 2004 they applied both domestically and cross-border.

The issue was dealt with under the freedom of establishment clause because lenders were related and owned shareholdings giving them definite influence on the borrower.

Non-EU lenders were denied protection under the free movement of capital provision, because national rules applied to substantial shareholdings and any restriction of the freedom was an indirect effect of the restriction of the freedom of establishment (which does not apply to third countries).

The Court held that, although the U.K. thin cap rules imposed a discriminatory restriction on the freedom of establishment, they could be justified as a measure to combat tax abuse if:

- they were designed to apply only to purely artificial arrangements, entered into for tax reasons alone, on the basis of objective and verifiable elements;
- on each occasion on which the existence of such an arrangement cannot be ruled out, the taxpayer was given an opportunity, without undue burden or administrative constraints, that the transaction was carried out for a genuine commercial reason other than to gain a tax advantage; and
- they applied only to the portion of the payment that exceeded an arm's-length amount.

#### 2. Italy's New Rules on Deductibility of Interest

Italy enacted thin capitalization rules in 2004. At the time, the ECJ had already issued its decision in *Lankhorst-Hohorst*, holding that German thin cap rules applicable only to interest paid or accrued to foreign related lenders (as opposed to resident lenders) violated the freedom of establishment and could not be justified because they did not target only wholly artificial arrangements designed to circumvent German law.

To avoid similar challenges, Italy made its thin cap rules applicable domestically. Italy then changed its rules in the Budget Law for 2008.

Under previous law, if the ratio of a borrower's debt held or guaranteed, and a borrower's equity owned, by a qualified shareholder or its related parties exceeded 4 to 1, the interest paid or accrued on the debt directly or indirectly held or guaranteed by a qualified shareholder or its related parties in excess of the permitted debt-equity ratio was recharacterized as a dividend and was not deductible by the borrower.

The debt-equity ratio was computed both at the aggregate level of all qualified shareholders (and related parties) and at the level of each single qualified shareholder (and related parties), to determine the applicability of the rules and to compute the amount on non-deductible interest.

Qualified shareholders were defined as shareholders that controlled the borrower or owned at least 25 percent of the borrower's stock. Related parties were defined as companies controlled by a qualified shareholder. The borrower could avoid the application of the rules by proving that the financing was obtained through its own credit capacity and not as a result of its relationship with the related-party lender or guarantor.

Also, under previous law, interest was nondeductible to the extent that it was allocated to stock that qualifies for participation exemption under the equity pro rata rule, or to the borrower's exempt income under the general pro rata rule.

The new rules repealed the thin capitalization, equity pro rata, and general pro rata rules and replaced them with a new limitation on the deductibility of corporate interest.

<sup>21</sup>For the judgment, see *Doc 2007-6302* or *2007 WTD 50-9*; for analysis, see Tom O'Shea, "Thin Cap GLO and Third-Country Rights: Which Freedom Applies?" *Tax Notes Int'l*, Apr. 23, 2007, p. 371, *Doc 2007-9386*, or *2007 WTD 83-9*.

<sup>22</sup>For the judgment, see *Doc 2002-27361* or *2002 WTD 241-23*.

Under the new rules, interest expenses can be deducted to the extent of interest income. Any excess of interest expenses over interest income (net interest expense) is deductible up to an amount not exceeding 30 percent of borrower's gross accounting profit or earnings before interest, taxes, depreciation, and amortization (limitation amount). The excess of net interest expense over the limitation amount (excess interest) can be carried over to and be deducted in future years, to the extent of the limitation amount available in those years.

Initially the bill provided for a five-year carryover period, increased to 10 years for the excess interest accrued in the first 3 years of the application of the new rules. In its final version, the Budget Law allows for indefinite carryover. Similarly, beginning from the third year of application of the new rules, any excess of the limitation amount over the net interest expense of a tax year can be carried over to (and increase the limitation available in) future years.

Excess interest of a member of a tax consolidated group can be transferred to and deducted by another member of the group (up to the limitation amount available to it). Similarly, the excess limitation of a member of the group can be transferred to another member of the group and increase the ability of the other member to deduct its own net interest expense. For this purpose, a tax group includes foreign affiliates that would qualify for consolidation under domestic tax consolidation rules.

General partnerships and limited liability partnerships are not subject to the limitation on interest deduction. However, the ability to get around the limitation by moving the debt at the level of the partnership and pass the partnership's losses through to the corporate partners has been immediately curtailed by the legislature, who enacted an antiabuse rule, according to which a partner's share of the partnership's losses can be offset only against that partner's share of that partnership's income passed through in future years (up to five years).

Based on the literal meaning of the statute, the antiabuse rule does not apply to joint stock or limited liability companies that elect to be treated as partnerships under Italy's check-the-box rules.

Banks, financing companies, and insurance companies are outside the scope of the new limitation on interest deductions.

#### D. Which Freedom Applies?

The ECJ clarified the relationship between the freedom of establishment and the free movement of capital as it applies in cases involving nonmember states'

investors, with its decision in *Lasertec* (C-492/04),<sup>23</sup> issued on May 10, 2007; *Thin Cap GLO* (C-524/04),<sup>24</sup> issued on March 13, 2007; and *Hölbock* (C-157/05),<sup>25</sup> issued on May 14, 2007.

The Court also provided important clarifications on the scope of the free movement of capital provision in its decision in *Skatteverket v. A* (C-101/05, December 18, 2007), which also held that the need for fiscal supervision and control might be a valid justification of restrictive tax rules for transactions with third countries.

According to the ECJ, the application of one of the two freedoms depends on the exact purpose and scope of the national tax rules.

When the national tax rules apply only to situations in which a foreign taxpayer owns a significant shareholding, giving him some definite influence on a member state's resident company, the case must be tested under the freedom of establishment, and any restriction on the free movement of capital is only an indirect consequence that does not trigger the application of article 56 of the EC Treaty.

In contrast, when the national tax rules apply regardless of the size of the investments or the shareholdings involved, both the freedoms apply concurrently, and the national rules must be tested separately under each of them to determine whether they are compatible with EU law.

##### 1. *Lasertec*

*Lasertec* was a Swiss company that owned 66 percent of the stock of *Lasertec Gesellschaft*, a German subsidiary. *Lasertec* granted a loan to its German subsidiary and the German tax authorities recharacterized the interest on the loan as nondeductible dividends under the German thin capitalization rules and disallowed the deduction to the German subsidiary. *Lasertec* challenged the decision and the case was referred to the ECJ to determine whether the German rules were discriminatory and violated the EC Treaty. The German thin cap rules were held incompatible with EU law in *Lankhorst-Hohorst*.

The case apparently could fall simultaneously under the application of two fundamental freedoms: the freedom of establishment, because the Swiss parent had exercised its freedom to establish and conduct business in Germany through a German subsidiary; and the free

<sup>23</sup>For the judgment, see *Doc 2007-12617* or *2007 WTD 102-7*; for analysis, see Tom O'Shea, "Third Country Denied Freedom of Establishment Rights in *Lasertec*," *Tax Notes Int'l*, June 4, 2007, p. 990, *Doc 2007-12581*, or *2007 WTD 102-1*.

<sup>24</sup>See *supra* note 21.

<sup>25</sup>For the judgment, see *Doc 2007-12618* or *2007 WTD 102-8*; for analysis, see Tom O'Shea, "*Hölbock*: Austrian Dividend Tax Rules Found Compatible With EC Treaty," *Tax Notes Int'l*, June 11, 2007, p. 1131, *Doc 2007-12910*, or *2007 WTD 117-9*.

movement of capital, because the extension of a loan in exchange for interest is a way to employ or obtain capital.

The application of either freedom would have dramatically different outcomes: The freedom of establishment would not protect the Swiss parent, because it does not apply outside the EU. The free movement of capital would protect the Swiss parent, because it applies also to third country taxpayers. The Swiss parent sought protection under the free movement of capital.

The European Commission argued that the German rules could be examined only on the basis of the freedom of establishment, because they are designed to apply only to related lenders who hold substantial shareholdings in the borrower “capable of conferring a determinative influence in respect of the company in which the holding is held.” Therefore, the rules “fell entirely within the material scope of the freedom of establishment” and the free movement of capital should not be considered.

The ECJ agreed, noting that “to ascertain whether national legislation falls within one or the other of the freedoms of movement, the purpose of the legislation at issue must be taken into consideration.” The German rules applied only to shareholdings that gave shareholders and lenders a definite influence on the decisions of the company and allowed shareholders to determine its activities, and therefore came within the scope of the freedom of establishment.

According to the ECJ, any restrictive effects on the free movement of capital “must be seen as an unavoidable consequence of the restriction on freedom of establishment . . . and do not justify an examination of that measure in the light of article 56 and 58 EC.”

## 2. *Thin Cap GLO*

The decision in *Lasertec* is consistent with the ECJ ruling in *Thin Cap GLO* delivered a few months before.

There, U.K. thin capitalization rules came under scrutiny and the ECJ held that:

national provisions which apply to holdings by nationals of the Member State concerned in the capital of a company established in another Member State, giving them definite influence on the company’s decision and allowing them to determine its activities, come within the substantive scope of the provision of the EC Treaty on freedom of establishment.

Because the U.K. rules applied “only to situations where the lending company had a definite influence on the borrowing company or is itself controlled by a company which has such an influence,” the thin cap rules primarily affected the freedom of establishment, and any restrictive effects on the free movement of capital “must be seen as an unavoidable consequence of any restriction on freedom of establishment.”

Therefore, the ECJ did not apply the free movement of capital, and those taxpayers who were residents in third countries (including the United States) lost the case on the basis that the freedom of establishment does not apply to nonmember states.

In *Fidium Finanz* (C-452/04), the ECJ had examined German law in relation to a Swiss company’s supply of banking services and loans to German residents on the Internet and held that German rules primarily imposed restrictions to the access to German financial markets for companies established in nonmember states; as a consequence, they affected primarily the freedom of provision of services and “any restrictive effects on the movement of capital were merely an inevitable consequence on the restrictions imposed on the provision of services.” The Swiss company was not entitled to any protection under the freedom of services, which applies only to EU member states.

In a nontax case, *Commission v. Netherlands (Golden Share)* (C-282/04 and C-283/04), the ECJ held that the Dutch rules on special shares granting the state special rights of prior approval of some management decisions in Dutch privatized companies applied to all movements of capital, including direct and portfolio investments, and therefore they had to be regarded as a restriction of free movement of capital within the meaning of article 56 of the EC Treaty to the extent that they were likely to prevent or limit the acquisition of shares in Dutch companies concerned or to deter investors from other member states from investing in the capital of such companies. According to the ECJ, the Dutch rules might also prevent a foreign shareholder from taking controlling holdings in the Dutch companies and might involve a violation of freedom of establishment. However, any restriction of the freedom of establishment in this case would be a direct consequence of the obstacles to the free movement of capital, and once a violation of the free movement of capital of article 56 is established, there is no need to do any separate examination of the rules under the freedom of establishment clause of article 43.

## 3. *Hölbock*

*Hölbock* deals with taxation on inbound dividends paid to an Austrian shareholder from a company resident in a third country under Austrian tax law.

*Hölbock*, an Austrian resident individual, owned two-thirds of the stock of a Swiss resident company, CBS Switzerland, which owned 100 percent of the stock of an Austrian resident company, CBS Austria. The Swiss company distributed a dividend to *Hölbock*. Under the Austrian tax legislation at the time of the case, dividends paid to an Austrian resident individual by an Austrian resident company were taxed at a reduced half-tax rate, whereas the dividends paid by a nonresident company were subject to the ordinary income tax rate. The rules were in place before December 31, 1993.

Hölbock challenged the Austrian tax rules under article 56 of the EC Treaty, according to which he was free to invest his capital outside of his resident state, and should have been taxed on the income from his non-Austrian investments at the same rate that applied to his income from Austrian investments.

Hölbock owned a substantial shareholding in the Swiss company and therefore, under the definite influence test, the freedom of establishment of article 43 of the EC Treaty could apply. At the same time, by investing his capital in the stock of the Swiss company, Hölbock had exercised his freedom of moving his capital and investing outside of his residence state, and therefore also the free movement of capital of article 56 of the EC Treaty could apply.

The Court noted that to determine which freedom applied, it was necessary to take into account the purpose of the national tax rules under consideration. The Austrian tax rules applied to all foreign dividends, both direct and portfolio dividends, regardless of the size of the shareholding involved. Consequently, the rules could affect both direct investments and portfolio investments and could “fall within the scope of both article 43 EC on freedom of establishment and article 56 EC on free movement of capital.” Thus, the Court tested the Austrian rules separately under both freedoms.

**Freedom of Establishment.** The Court observed that the freedom of establishment does not apply to situations involving establishment in a third country. The freedom of establishment did not apply to Hölbock because he owned two-thirds of the capital of a company resident in Switzerland, a non-EU member state. Although this gave him a definite influence and control over the Swiss company, it did not constitute an exercise of the right of establishment in another EU member state granted under article 43 of the EC Treaty.

**Free Movement of Capital.** The Court held that the Austrian rules constituted a restriction on the free movement of capital, because, by subjecting dividends distributed by foreign companies to a higher level of tax than dividends distributed by domestic companies, the rules discourage Austrian residents from investing their capital in companies that were resident outside of Austria. Since the free movement of capital provisions of the EC Treaty also apply to investments made in third countries that are not member states, the Austrian rules violated article 56 of the EC Treaty. Therefore, the Court confirmed that an EU national owning two-thirds of the stock of a third-country (Swiss) company can invoke the free movement of capital provisions of the EC Treaty if national restrictive tax rules (such as the Austrian dividend rules) apply to both portfolio and direct dividends received from foreign companies.

However, the Court held that the Austrian rules were covered by the grandfathering rule of article 57(1) of the EC Treaty, which saves restrictions on direct

investments in a non-EU member state existing on December 31, 1993. The Austrian rules fell within that exception because they were in place before that date.

*Hölbock* is an important judgment. It confirms that the free movement of capital in transactions with third countries cannot be restricted except in the limited circumstances provided in the EC Treaty (article 57(1)) or by national rules that are justified by reasons of general interest and meet the necessity and proportionality tests. The Court confirmed that EU nationals (individuals and companies) can invoke the free movement of capital even when they hold controlling shareholding in companies located in third countries, in situations in which the national tax rules apply to both direct and portfolio investments in a way that restrict such free movement “irrespective of the extent of the holding which the shareholder has in the company making the distribution.” In those circumstances, the national rules may fall within the scope of both the freedom of establishment and the free movement of capital and are tested separately under each of them.

#### 4. *Skatteverket*

In its decision in *Skatteverket v. A* (C-101/05, Dec. 18, 2007),<sup>26</sup> the ECJ examined the Swedish tax rules that grant nonrecognition treatment to a distribution of stock of a subsidiary by a Swedish company in a pro rata spinoff, but treat it as a taxable dividend if the distributing company is a foreign company resident in a country outside the EU or EEA with which Sweden does not have a treaty or tax information exchange agreement.

In the case at hand, a Swiss company distributed stock of one of its subsidiaries to a Swedish shareholder in a spinoff that was treated as taxable dividend in Sweden.

Sweden and several other member states argued that the free movement of capital provision of article 56 should be interpreted more narrowly when it applies to cross-border transactions with third countries and it does not apply to dividends from non-EU member states.

The Court disagreed and observed that the free movement of capital is enshrined in article 56(1) of the EC Treaty “under the same terms for movements of capital taking place within the Community and those relating to relations with third countries,” and, therefore, it should be interpreted in the same manner regarding cross-border transactions between member

<sup>26</sup>For analysis, see Tom O’Shea, “Swedish Tax Treatment of Third-Country Dividends,” *Tax Notes Int’l*, Jan. 14, 2008, p. 136, *Doc 2008-290*, or *2008 WTD 6-10*; for analysis of the AG opinion, see Leif Mutén, “Swedish Restriction on EC Freedom May Be Justified, ECJ AG Says,” *Tax Notes Int’l*, Sept. 24, 2007, p. 1132, *Doc 2007-21144*, or *2007 WTD 181-3*.

states and third countries as it is regarding cross-border transactions between member states.

The ECJ, however, held that the Swedish rules were justified by the need to exercise fiscal supervision over transactions with third countries.

#### 5. Impact on Italian Dividend Rules

The cases examined above suggest that we take a second look at Italian rules on taxation of dividends, as amended by the Budget law of 2008 and their compatibility with the free movement of capital.

Since the Italian rules apply to both portfolio and intercompany dividends, regardless of the size of the shareholding held in Italian companies, they must be separately tested under both the freedom of establishment and the free movement of capital, for dividends paid both to EU and non-EU investors.

**a. Resident Shareholders.** Italy taxes dividends paid by an Italian company to resident shareholders at the following (effective) tax rates:

- 1) corporate shareholders: 1.375 percent;
- 2) individual portfolio shareholders: 12.5 percent;
- 3) individual nonportfolio shareholders: 16.5 percent;<sup>27</sup> and
- 4) individual shareholders owning stock in a business or through partnerships: 16.5 percent or lower.

**b. Nonresident Shareholders.** Outbound dividends paid by Italian companies to nonresident shareholders are taxed at the following tax rates:

- 1) individual non-tax-treaty shareholders:<sup>28</sup> 27 percent;
- 2) individual tax treaty shareholders:<sup>29</sup> 15 percent;
- 3) EU parent-subsidiary corporate shareholders: 0 percent;
- 4) EU non-parent-subsidiary corporate shareholders: 1.375 percent;
- 5) third-country tax treaty corporate shareholders: 15 percent, 10 percent, and 5 percent; and
- 6) third-country non-tax-treaty corporate shareholders: 27 percent.

If we compare the tax treatment of dividends to corporate shareholders in group A (residents) and group B (nonresidents), we can see there is no discrimination as far as the foreign shareholders that are companies resident in an EU member state. Indeed, as a result of the changes in the law enacted with the 2008 Budget Law, EU companies are entitled to the same

tax treatment as resident companies, except when they qualify for the total elimination of the tax under the parent-subsidiary directive.

However, if we compare the tax treatment of dividends to resident companies and to foreign companies resident in a third country (number 1 in group A vs. numbers 5 and 6 in group B), we can see there is a discrimination, in the sense that dividends paid to foreign companies are taxed more heavily than dividends paid to resident companies.

Nonresident companies get a 5 percent withholding tax rate, in the best case scenario, when they qualify for the minimum tax rate for intercompany dividends under the tax treaty,<sup>30</sup> compared with the 1.375 percent effective rate for resident companies.

Otherwise, they may be taxed either at the 15 percent or 10 percent rates under the tax treaty or at the full 27 percent domestic rate if no treaty applies.

Because the Italian rules apply to both portfolio and intercompany dividends regardless of the size of the shareholding held in the Italian company, the above rules violate the free movement of capital provision of article 56 of the EC Treaty as far as third-country shareholders are concerned. The restriction to the free movement of capital does not seem to be justified by any overriding reason of public interest.

If the foreign shareholder cannot credit the withholding in its state of residence under the tax treaty, the discrimination would not be corrected and the Italian rules could not stand.

For dividends to foreign companies resident in a non-tax-treaty country with no exchange of information agreement with Italy, the restriction could not be justified under the need for fiscal supervision (confirmed in *Skatteverket v. A*), because the more favorable tax treatment afforded to domestic shareholders is not subject to particular conditions for which specific information should be made available by the foreign country's taxing authority.

A different tax treatment also applies to dividends paid to individual shareholders, which may give rise to challenges to the rules under EU law.

#### E. Fiscal Supervision: *Skatteverket*

The ECJ in *Skatteverket v. A* held that national tax rules denying nonrecognition treatment to distributions by foreign companies resident in third countries with which a member state does not have a tax information exchange agreement were justified by the need to exercise fiscal supervision over transactions with third

<sup>27</sup>This is equal to the 40 percent taxable portion of the dividend multiplied by the top graduated tax rate of 43 percent.

<sup>28</sup>Whether resident in EU member states or in third countries.

<sup>29</sup>Whether resident in EU member states or in third countries.

<sup>30</sup>To date, Italy has no tax treaty providing for 0 percent withholding rate on dividends.

countries and allow the member state to verify that the conditions for the beneficial tax treatment were actually met.

The conditions required by Swedish law to grant nonrecognition treatment of foreign spinoffs included that:

- the distribution is pro rata;
- the parent company's shares in the subsidiary company are all distributed; and
- the shares of the subsidiary after the distribution are not held by any undertaking that belongs to the same group as the parent company.

Checking compliance with those conditions might prove impossible in the absence of tax information exchange agreements with the third country involved. For this reason, Swedish law denied nonrecognition treatment to distributions from companies in countries that do not allow an effective exchange of information.

Sweden had concluded a tax treaty with Switzerland, but there was a dispute over the exchange of information obligations under that treaty. Therefore, Swedish tax authorities held that the distribution was taxable.

The ECJ held that the scope and interpretation of the free movement of capital provision regarding transactions with third countries are the same as regarding transactions within the EU. However, the Court also noted there is a different legal context when third countries are involved. Within the EU, member states can rely on common legal ground and a greater degree of legal integration that can ensure cooperation between national tax authorities, including the exchange of information granted by Directive 77/799/EEC and common rules on the annual accounts of some public companies in the Fourth Council Directive 78/660/EEC.

Instead, in situations involving third countries, even if the taxpayer could provide the relevant information, the tax authority would still have to assess the evidence provided and could do so only by obtaining the necessary information from the third-country tax authority. The lack of legal means or normal procedures to obtain such information may justify not granting the tax advantage to the taxpayer under such a circumstance.

The decision is important because it allows member states to limit the availability of some tax benefits (for example, the exemption of stock gains or dividends under domestic participation exemption rules) for transactions involving companies resident in non-EU member states, including traditional offshore tax havens, because those countries agree to operate an effective

exchange of tax information, and can be used as a tool to force those countries to revise their bank and tax secrecy laws and enter into such agreements.

## V. Conclusion

The ECJ decision in *Marks & Spencer* was not the complete evisceration of the U.K. rules that was expected. The ECJ recognized the government's right to put limits on the use of foreign losses, particularly in abusive situations, and required that taxpayers show that the losses could not be absorbed in the country in which they were generated, for them to be used in the home country.

Several subsequent decisions by the ECJ, such as the IRAP decision (*Banca Popolare di Cremona* (C-475/03)), the *D* case (C-376/03) on tax treaties, and the *Cadbury Schweppes* case on CFC rules were all more limited than what the ECJ's previous decisions led observers to expect.

In 2007 the ECJ confirmed that approach. Several decisions — most notably *Thin Cap GLO*, concerning U.K. thin cap rules; *Oy AA*, concerning cross-border losses; and *Skatteverket v. A*, concerning the taxation of inbound distributions — allowed the member states to put limits on the application of some tax benefits to cross-border transactions, on account of protecting their tax base and combating tax abuse.

Before *Marks & Spencer* it was widely believed that the ECJ took an aggressive position on direct tax matters to force the political branches of the EU to move toward corporate tax rate harmonization, as the commission had advocated for many years.

However, deciding cases to force action by the legislature can be dangerous. Many member states are strongly opposed to direct tax harmonization, and deciding cases in the expectation that the political branches will act can have unexpected tax consequences, like a race to the bottom with no harmonization.

The ECJ can afford to be more lenient without creating unacceptable barriers to trade and investments within the EU.

Of course, the ECJ's decisions still have a huge impact on national tax laws, as the example of Italy briefly discussed in this article illustrates. Also, the member states need to fine-tune their domestic laws to make sure they satisfy the ECJ's tests for a justification of restrictions on fundamental freedoms. However, the ECJ would seem to be willing to give more opportunities to put limits to the fundamental freedoms, provided they do not create major obstacles to the implementation of the single market. ◆