EU Tax News
PRICEWATERHOUSECOOPERS
EU Direct Tax Group Part of the International Tax Services Network

Issue 2008 – nr. 004 **May – June 2008**

This issue of the EU Tax Newsletter has been prepared by members of PwC's EU Direct Tax Group (EUDTG). Should you be interested in receiving this free newsletter automatically in the future, then please register online via: www.pwc.com/eudirecttax.

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ECJ CASES

Belgium – ECJ judgment on Belgian obligations regarding the implementation of the Merger Directive (C-392/07)

On 8 May 2008, upon a referral by the European Commission, the ECJ ruled that Belgium had failed to fulfil its obligations with respect to the implementation of Merger Directive 2005/19/EC of 17 February 2005 amending Merger Directive 90/434/EEC. After having sent a Reasoned Opinion to Belgium on 1 February 2007, the Commission decided to bring the matter before the ECJ.

In this respect it should be noted that on 27 June 2008, the Belgian Council of Ministers approved the proposal of law implementing this Directive in the Belgian Income Tax Code and therefore allowing a tax neutral regime for restructurings between EU-based companies. The Belgian Act is expected to be voted by the Parliament before the end of the year.

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Belgium – AG opinion on Belgian application of the Parent subsidiary Directive: Cobelfret case (C-138/07)

On 8 May 2008, AG Sharpston issued her opinion on the preliminary question whether Article 4 of Parent Subsidiary Directive precludes national legislation under which dividends received are first included in the basis of assessment of the parent company and subsequently deducted only in so far as the parent company has taxable profits (see also EUDTG Newsalert NA 2007 - 012 of 30 March 2007).

With respect to the compatibility of the Belgian legislation with Article 4(1) of the Directive, the AG opined that the Belgian tax provisions at stake entail that dividends received from a subsidiary are always included in the parent company's basis of assessment but they are not always deducted, since no deduction is operated where the parent has no taxable profits for the same period. In such a case, accounting for the dividends in the basis of assessment will lead to higher tax overall, since it will reduce the amount of the loss which can be carried forward. According to the AG, by not providing for the systematic exemption of dividends, Belgium subjects the exemption of dividends to a condition which is not envisaged by the Directive. In addition, the AG is also of the view that it would not be appropriate for the Court to limit the effects of the ruling in time.

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Estonia – ECJ referral on Estonian withholding tax on outbound dividend payments

On 13 May 2008, the Tallinn District Court (the Court) concluded that the case at issue on outbound dividends may justify the request for a preliminary ruling from the ECJ and gave time to the parties until 10 June 2008 to present their views on the questions to be submitted to the ECJ.

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

The Court stated that the question relates to whether the foreign fund established as a legal entity should be compared to an Estonian fund established as a (non-taxable) contractual fund (i.e. pool of assets) or to a (taxable) Estonian legal entity. It noted that there might be timing differences in taxation even if a comparison is made to a legal entity, but the justifications may have different weight depending on the comparisons used. Referring to Case C-379/05 (*Amurta*), the Court stated that it is necessary to determine the different treatment and whether restriction to the free movement of goods (*sic!*) can be justified by necessity to safeguard the cohesion of the tax system and the division of taxing rights between the Member States. It could not find sufficient clarifications from the existing ECJ case law to decide itself upon the case.

Previously, the Tallinn Administrative Court, as the court of first instance, had decided that it had no obligation to refer the case to the ECJ and it also considered the Estonian Income Tax Act to be compatible with the EC Treaty with regard to the taxation of dividend payments to EU investment funds. It found that the comparison should be made purely based on the legal status of the entity. As both resident and non-resident legal entities suffer economic double taxation if their participation in an Estonian company is less than 20% they are therefore treated equally. The timing difference resulting from taxation of non-resident entities by withholding, but allowing resident corporations to defer the tax charge until they make further distributions out of the dividends received can be justified by the coherence of the Estonian tax system and the necessity to guarantee the effectiveness of fiscal supervision.

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Germany – ECJ judgment on German corporate tax uplift under the former imputation system: Burda case (C-284/06)

Burda, a German resident company, which was owned by a Dutch resident shareholder (BV) to 50%, distributed dividends in 1998 mainly out of taxed equity. Under the former German imputation system, the distributable equity of a resident corporation was divided into equity baskets. Depending on which equity basket was utilised, the corporate tax of the distributing company was reduced (taxed basket) or uplifted (untaxed basket/EK02) to 30% or was not levied (shareholder contribution basket). In order to avoid double taxation, resident shareholders were granted a full imputation credit equal to the corporate tax paid. However, non-resident shareholders were not entitled to this imputation credit.

Due to a tax audit, the taxed equity basket was reduced retroactively. Although *Burda* had no other untaxed equity, it was not allowed to utilise its shareholder contribution basket, but suffered a tax uplift of 30%. The tax was uplifted in order to safeguard the matching of the imputation credit and the corporate tax burden, because *Burda* had issued an irrevocable

certificate to its other 50% resident shareholder showing the imputation credit due on his part of the dividend. The uplift was calculated on the whole dividend. *Burda* appealed against the tax assessment. The German Supreme Tax Court referred to the ECJ and asked whether, after the ECJ´s *Athinaiki* decision (C-294/99), the tax uplift was allowed under the Parent Subsidiary Directive or infringed the fundamental freedoms.

On 26 June 2008, the ECJ gave its decision on this case. Concerning the compliance with the Parent Subsidiary Directive, the ECJ was of the opinion that the tax uplift did not fulfil the requirements of a withholding tax, because it was rather a tax burden of the subsidiary than of the parent company. In contrast to the *Athinaiki* case, the ECJ rejected an economic assessment of the corporate tax uplift mechanism. The Court came to the conclusion that the tax uplift was allowed under the Parent Subsidiary Directive. Therefore, the principles of the *Athinaiki* decision seem to be overruled.

The ECJ supported the view that the freedom of establishment was applicable with regard to the 50% shareholding of BV in *Burda*. As *Burda´s* tax burden due to the tax uplift did not depend on the place of residence of the shareholders, the ECJ did not recognise an unequal treatment. Furthermore, the Court denied an infringement by an equal treatment of unequal situations. Thus, the ECJ concluded that the tax uplift did not infringe the freedom of establishment. See also EUDTG Newsalert NA 2008 – 016.

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Germany – ECJ judgment on German tax treatment of foreign losses: Lidl Belgium case (C-414/06)

On 15 May 2008, the ECJ ruled that it is not contrary to EC Law that a Member State prohibits the offsetting of losses of a Permanent Establishment (PE) situated in another Member State if a double tax treaty allocates the right of taxation of the PE's income to the other Member State and the PE losses may be offset in later accounting periods in that Member State.

The German resident claimant *Lidl Belgium GmbH & Co. KG* had established a PE in Luxembourg which generated losses in 1999. The claimant sought to offset these losses against its German profits. However, as income of a Luxembourg PE is exempted under Germany's double tax treaty (DTT) with Luxembourg, the German tax authorities argued that Luxembourg losses cannot be offset against domestic profits. The Federal Tax Court, referring the case to the ECJ, expressed doubts as to whether the non-recognition of the Luxembourg losses is compatible with EC Law principles, in particular with those established in the *Marks & Spencer* (C-309/06) judgment.

In its judgment, the ECJ set out that the establishment of a PE, being an autonomous fiscal entity as demonstrated by the provisions the OECD Model Tax Convention, principally falls within the scope of Art. 43 EC. The possibility to offset losses of a domestic PE by the principal company constitutes a tax advantage which is not available where the PE is situated in another Member State. Hence, the ECJ considered a restriction of the freedom of establishment to be present.

The ECJ considered that the restriction may be justified by the principles that were established in the *Marks & Spencer* case. Confirming the AG's view that not all three justifications must be fulfilled cumulatively, it found two justifications to be relevant for the case at hand. Firstly, the ECJ stated that it would seriously undermine the balanced allocation of taxing rights if companies were given the right to choose in which Member State their losses would be taken into account. As the home State does not have the right to tax under the DTT, the objective of preserving the allocation of taxing rights may thus justify the tax regime in question as it safeguards the symmetrical treatment of profits and losses. Secondly, the ECJ viewed that there is clearly a danger that the same losses will be used twice as the Member State of the principal company which offset the losses might be prevented from taxing the profits after the PE had become profitable.

The ECJ, however, did not follow the AG's considerations on the principle of proportionality. It dismissed the recapture mechanism proposed by the AG and refrained from clarifying the relevance of cash flow disadvantages. Instead, the ECJ referred to its *Marks & Spencer* judgment in which it had held that a measure might be disproportionate where a non-resident subsidiary had exhausted the possibilities for taking losses into account in the Member State where the losses were incurred. As the Luxembourg tax legislation provides for the possibility of a loss carry-forward, and *Lidl Belgium*'s Luxembourg PE had in fact benefited from an offset against profits in 2003, the ECJ found the claimant to have failed to show that the conditions laid down in *Marks & Spencer* were fulfilled. Emphasising the legitimate interest of the Member State to exercise its right of taxation, the ECJ found the German tax regime to be proportionate. See also EUDTG Newsalert NA 2008 – 014.

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Hungary – AG opinion on transfer of the real seat by a company registered in Hungary to another EU Member State: Cartesio case (C-210/06)

On 22 May 2008, AG Maduro issued his opinion on whether a company registered in an EU Member State can transfer its operational headquarters to another EU Member State without restrictions.

Cartesio is a limited partnership in Hungary that asked the Court of Registry to record in the Company Registry the transfer of its operational headquarters from Hungary to Italy in November 2005. Cartesio would like to remain incorporated in Hungary and therefore subject to Hungarian Company Law without being dissolved. The Court of Registry rejected the request. Cartesio brought an appeal against this decision before the Court of Appeal, Szeged, which referred preliminary questions in relation to this case to the ECJ.

In the opinion of the AG, national rules allowing a company to transfer its operational headquarters only within the national territory clearly treat cross-border situations less favourably than purely national situations, and therefore discriminate against cross-border establishment. In the present state of EC Law, Member States are free to choose whether they want to have a system of rules grounded in the real seat theory or in the incorporation theory; although a minimal degree of mutual recognition and coordination of these various

systems should be required. However, it cannot be accepted that Member States enjoy an absolute freedom to determine the 'life and death' of companies constituted under their domestic law, irrespective of the consequences for the freedom of establishment. Restrictions on the 'emigration' of a company are permissible only if they are justified on grounds of general public interest.

The final conclusion of the AG was that the ECJ should state in its decision that national rules that make it impossible for a company to transfer its registered office from an EU Member State to another are incompatible with EC Law. See also EUDTG Newsalert NA 2008 – 015.

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Netherlands – ECJ judgment on Dutch credit of foreign dividend withholding tax: Orange European Smallcap Fund NV (C-194/06)

Orange European Smallcap Fund NV (OESF) is a Dutch resident portfolio investment fund, subject to the Dutch special corporate income tax regime for such funds. This regime provides for (1) taxation of the fund at a rate of 0% and (2) a credit of dividend withholding tax (DWT) to the fund with regard to dividends received by the fund. Dutch DWT is levied upon distribution of dividends by the fund to its shareholders. This Dutch tax regime is aimed at an equal treatment of direct portfolio investments on the one hand and indirect portfolio investments – through an intermediary investment fund – on the other hand.

In 1997, OESF - whose shareholders reside in various (EU and non-EU) countries - received dividends from various countries, including Portugal and Germany. These dividends had been subject to foreign DWT. OESF claimed a (substitute) credit of those foreign withholding taxes. This credit was, pursuant to Dutch legislation, restricted in two ways. Firstly, no credit of DWT was granted with regard to the dividends from Portugal and Germany, on the basis of the non-existence (in 1997) of tax treaties between the Netherlands and those countries providing for a right to a credit of foreign DWT against Dutch income tax. Secondly, with regard to the dividends from other foreign countries, the credit of DWT was reduced in proportion to the participation in OESF by shareholders not residing in the Netherlands. OESF claimed a full credit of all foreign DWT. The case of OESF ended up at the Dutch Supreme Court, which referred the case to the ECJ for a preliminary ruling.

On 20 May 2008, the ECJ handed down its judgment. With regard to the lack of a credit of Portuguese and German DWT, the ECJ points out that those foreign dividends are treated in the same way as Dutch based dividends, since portfolio investment funds are taxed by the Netherlands at a rate of 0% (DWT) in both cases. The fact that dividends from Germany and Portugal are subject to a greater tax burden when compared to dividends distributed by Dutch companies is not attributable to the Dutch legislation at issue; it is rather the result of the parallel exercise of fiscal sovereignty by those Member States. Hence, according to the ECJ, the fact that the Netherlands do not grant a credit of DWT levied by Germany and Portugal does not constitute a restriction on the free movement of capital. However, the fact that the Netherlands treat dividends received from one Member State different from dividends received from another does imply a restriction on the free movement of capital. Nonetheless, this restriction is justified by objective differences between those respective situations, taking

into account the aim of the Dutch regime. If an individual investor had received dividends from Germany and Portugal directly (i.e. without the intervention of a portfolio investment fund), no credit of foreign DWT would have been available either. The lack of such a credit (as such) is not contrary to Article 56 EC, even if such a credit would have been available in respect of DWT on dividends stemming from countries with which the Netherlands have concluded tax treaties providing for credits or foreign DWT.

With regard to the second restriction of the credit granted to OESF, the ECJ ruled that the restriction of a credit of foreign DWT to the extent that the shareholders of OESF are not natural persons residing in the Netherlands or bodies subject to corporation tax there is contrary to Article 56 EC. This restriction cannot be justified by objective differences between portfolio investment funds with 'foreign' shareholders *vis-à-vis* portfolio investment funds with 'domestic' shareholders, since both categories of shareholders are subject to Dutch taxation and the Dutch regime does not adjust the credit of foreign DWT to the different levels of Dutch taxation to which the respective categories of shareholders are subject. According to the ECJ, Article 56 EC is breached in respect of both EU resident shareholders and shareholders residing in third countries.

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Spain – ECJ referral on Spanish winnings tax rules (C-153/08)

Under Spanish legislation, winnings from lotteries and betting organised by certain Spanish public and private bodies or entities are exempt from income tax. However, income from lotteries, games or betting organised by other national bodies or by foreign bodies, including those established in EU Member States or the EEA, is added to the taxable amount and subject to progressive rates of taxation.

The Commission sent a Reasoned Opinion to Spain on 15 December 2006 to request it to change its legislation. Spain's reply was negative and on 15 April 2008, the Commission brought a claim before the ECJ on the grounds that, by maintaining in force legislation taxing winnings from all types of lotteries, games and betting organised outside Spain, whereas winnings obtained from certain lotteries, games and betting organised within Spain are exempted from income tax, Spain is restricting the freedom to provide services and is thus failing to fulfil its obligations under EC Law. Spain argued that the exemption is not discriminatory as it is based on the nature of the organisers rather than on the place of their establishment. However, the Commission considered that the exemption set forth in the Spanish legislation constitutes a discrimination prohibited by the EC Treaty, as the favourable treatment is not open to other EU entities of the same nature as those mentioned for the exemption purposes, and the exemption is reserved for certain entities which Spanish legislation defines precisely, and entities of other Member States, albeit of the same nature and in pursuit of the same objectives as the Spanish entities specified in the exemption rule, are excluded from the benefit of that exemption.

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NATIONAL DEVELOPMENTS

Finland – Central Tax Board judgment on Finnish withholding tax on cross-border portfolio dividends

The Finnish Central Tax Board (hereinafter "CTB") issued an advance ruling on 21 May 2008 (KVL 27/2008) covering the issue of intra-EU portfolio investment and withholding tax liability on cross-border portfolio dividend distribution. The CTB found the Finnish tax treatment of outbound portfolio dividends to be incompatible with the EC Treaty, in particular Article 56 on the free movement of capital.

A Swedish resident entity (Swedish AB) held approximately 9% of the shares in a Finnish resident company. Pursuant to Finnish domestic tax law and the tax treaty between Finland and Sweden, Finland was allowed to levy withholding tax on the Finnish source dividend at the rate of 15%. As the dividend income in question was tax exempt in Sweden, there was no tax credit available in Sweden. Therefore, the cross-border dividend was effectively taxed at a rate of 15%, entirely due to Finnish withholding tax. If the same dividend would have been distributed to a Finnish resident entity, no taxes would have been levied, i.e. the intra-Finland dividend would have been totally tax exempt.

In its ruling, the CTB stated that based on the free movement of capital in Art. 56 of the EC Treaty the tax treatment of a non-resident dividend recipient may not be more burdensome than the tax treatment of a Finnish resident dividend recipient. In the case at hand, the same dividend would have been tax exempt in the hands of a Finnish resident company regardless of the share of ownership. This being the case, the Finnish tax treatment was more burdensome in a cross-border situation than in a purely Finnish situation. As this more burdensome taxation was not relieved in Sweden, the CTB considered the EC Treaty to prevent withholding taxation in Finland.

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France – Administrative Court of Appeal judgment on French withholding tax due by foreign pension funds on capital gains

In three decisions dated 6 December 2007 (n° 06-3370, 06-3371 and 07-1717), the Administrative Court of Appeal of Paris (Court) held that the tax levy that applies in France to foreign pension funds – three Dutch Stichtings, acting as pension funds – on capital gains arising from the disposal of French real estate companies shares, is in breach of the 1973 France/Netherlands Tax Treaty's non-discrimination provisions and the EU's free movement of capital principle.

Three Stichtings sold shares in French real estate companies. The capital gain arising from the sale was subject to a 33.33% withholding tax in France. The French Tax Administrative Guidelines confirm that this tax levy should apply to foreign pension funds realising a capital gain in France. If the pension fund had been a French resident, it would not have suffered any taxation on such capital gains.

The non-discrimination clause in the France/Netherlands Tax Treaty prohibits discrimination based on the nationality of the taxpayer, individuals or companies. The Court considered that Dutch and French pension funds were in a comparable situation. As a result, their differential treatment is not compatible with the provisions of the non-discrimination clause. It should be noted that the same Court took an opposite decision in May 2007 in a similar case involving a Greek non-profit organisation.

The French Tax Authorities put forward that, based on the OECD's commentaries on Article 24 of the OECD Model Tax Convention (para. 8), the non-discrimination clause cannot be applied to non-profit organisations. The Court rejected this argument indicating that the OECD commentaries were introduced after the signature of the France/Netherlands Tax Treaty. Although it had already determined the incompatibility of the French withholding tax by reference to the France/Netherlands Tax Treaty, the Court also examined the compatibility of the withholding tax with the EU's free movement of capital principle (Article 56 of the EC Treaty). Referring to the ECJ's decision in the *Stauffer* case (C-386/04 of 14 September 2006), the Court declared that the tax is also in breach of this principle of EC Law.

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Germany – Federal Tax Court judgment on the applicable tax rate on profits derived from a German PE

On 5 March 2008, the Federal Tax Court (BFH) expressed serious doubts whether under EC Law the tax rate on profits generated by a German permanent establishment (PE) of a foreign corporation may be calculated by including the withholding tax rate for corporate dividends as applicable in the years in question (1993 and 1995).

The claimant, a Dutch resident corporation with several PEs in Germany pursued preliminary proceedings in order to suspend the execution of tax returns issued for its German PEs. With reference to the BFH judgment following the ECJ's decision in the *CLT -UFA* case (C-253/03), the Lower Tax Court in charge found any tax rate higher than 33,5% unlawful and suspended the tax returns to that extent, against which the claimant lodged an appeal.

In its ruling, the BFH, however, expressed doubts whether a tax rate higher than 30% would be in line with ECJ case law. The court held that in particular the judgement in the CLT-UFA case required that the profits of a PE and a subsidiary must be taxed alike in order to comply with EC Law. Although the Lower Tax Court sought to calculate the applicable PE tax rate by comparison of a subsidiary and a PE, it arrived, however, at the tax rate of 33,5 % by adding to the then applicable corporate tax rate on distributed corporate profits of 30% a further withholding tax of 5 % due on the amount distributed by a subsidiary.

The BFH, on the other hand, questioned whether the inclusion of withholding tax is in compliance with EC Law since any dividend tax paid in Germany would not have been creditable in the Netherlands at the time. Despite the fact that the Parent-Subsidiary Directive would have allowed for taxing dividend distributions, the BFH argued that in the absence of a tax credit nonetheless a breach of primary EC Law might be at hand.

The BFH further spotted some other legal issues which mainly relate to various technicalities of the former German imputation system.

As the BFH deemed these legal questions not to be answerable in preliminary proceedings, it suspended the tax returns to the extent that a tax rate of 30% has been exceeded.

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Germany – Lower Finance Court expresses serious doubts concerning exit taxation in the case of cross border movements of individuals with shareholdings

A German resident owned more than 50% of the share capital of two German resident corporations. In 2004 the individual moved to Portugal and sold the shares in 2005. First, the increase in value at the time of the movement was taxed in Germany according to sec. 6 AStG. Secondly, the disposal was taxed in Portugal. Portugal determined the taxable capital gain by subtracting the original costs of the shares. The Germany/Portugal double tax treaty did not foresee, unlike some other German treaties, a step-up in value at the time of the movement. Therefore, one part of the capital gain was taxed twice. The individual appealed against the German tax assessment notice and claimed for a suspension of execution. On 4 April 2008, the Lower Finance Court of Munich ruled only on the suspension. The matter itself is still pending. The suspension of execution has to be granted when the assessment notice could seriously be doubted lawful. The interim ruling indicates the actual attitude of the Finance Court regarding the compliance of the German exit taxation with EC Law.

The Court has doubts whether the exit taxation of sec. 6 AStG is in line with EC Law. The Court is of the opinion that both the AG as well as the ECJ stated in the *N* case (C-470/04) that an exit taxation was only justified to the extent that double taxation was avoided. As Germany taxed the increase in value irrespective of partial double taxation in Portugal, the Lower Finance Court considers there to be a breach of the freedom of establishment. In the Court's view, the possibility of a mutual agreement procedure does not lead to a different conclusion.

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Italy – Italy implements Merger Directive 2005/56/EC

On 2 July 2008, the Legislative Decree implementing the Directive 2005/56/EC of the European Parliament and of the Council dated 26 October 2005 on cross-border mergers of limited liability companies came into force.

The Directive should have been implemented by 15 December 2007. Due to the failure in its implementation, on 5 June 2008 the European Commission had sent formal requests, in the form of Reasoned Opinions (the second step of the infringement procedure laid down in Article 226 of EC Treaty), against 11 Member States, among them Italy.

In brief, the Legislative Decree provides for the following specific features of the implementation of the cross-border Merger Directive:

- in the case of conflict between the Italian legislation on mergers and the one of another Member State, the applicable law is that of the Member State where the company resulting from the merger will be located (section 4, paragraph 2);
- mainly mutual cooperatives, regulated by section 2512 of the Italian Civil Code, cannot take part of cross-border mergers (section 3, paragraph 2);
- the Notary is the competent Italian authority to check and, therefore, attest that:

  a) the Italian company involved in the cross-border Merger properly completed all the acts and the preliminary formalities requested by the Directive and, in the absence of specific rules provided for by the Directive, by the Italian legislation for the realisation of the cross-border Merger (section 11, paragraph 1);
  b) the merger itself was legally implemented where the company resulting from the merger is Italian (section 13, paragraph 1).

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Netherlands – AG opinion on discriminatory tax treatment of the acquisition of shares by third country residents

On 1 April 2008, the AG to the Dutch Supreme Court, Niessen, gave his opinion in Case No. 43 874. This case concerns a private individual, residing in Canada. He inherited 4.13% of the shares in a Dutch resident company from his father who had died in the Netherlands. The Dutch Tax Authorities refused to grant a provisional exemption and a deferred payment of inheritance tax on these shares. These facilities were – in case of non-resident heirs – only available if the inherited shares qualified as a substantial shareholding (5% of the shares or more). This minimal holding requirement was not imposed on Dutch resident heirs. The question arises whether this refusal of the tax advantage is a restriction of free movement of capital.

Given the fact that the situation involves a third country, the AG examined which freedom is applicable in this specific case. He observed that the tax advantage in question is not intended to apply only to those shareholdings which enable the holder to have a definite influence on a company's decisions and to determine its activities. As a consequence, Article 56 EC can be fully applied (*Holböck*, C-157/05, paragraphs 23 & 24).

The AG subsequently considered that the discriminatory treatment between resident and non-resident taxpayers *prima facie* infringes the free movement of capital. This restriction is not saved by the stand still clause of Article 57 EC, because the relevant provisions were put in place in 1997.

Such a restriction may nevertheless be allowed if it pursues a legitimate objective in the public interest, is appropriate to ensuring the attainment of that objective, and does not go beyond what is necessary to attain it. The AG is of the opinion that no such justification exists.

Specifically, the AG observed that the need for effective fiscal supervision may justify the restriction, because the grant of the tax advantage is dependent on satisfying certain requirements (e.g. the deferment of payment is ended in case of bankruptcy of the taxpayer).

The tax treaty between the Netherlands and Canada does not provide for a sufficient exchange of information between the competent authorities and Council Directive 77/799 concerning mutual assistance by the competent authorities of the Member States in the field of direct and indirect taxation does not apply to the facts of the case. Nevertheless, the AG is of the opinion that it would be disproportionate to refuse the tax advantage on these grounds. In his opinion the Netherlands has forfeited its right to invoke the need for an effective fiscal supervision as a justification for a restriction, because it would have granted the tax advantage if the taxpayer had received 5% of the shares or more, in which situation the same problems with respect to fiscal supervision would have arisen. Apparently, the need to ensure effective fiscal supervision is not the 'real' reason for the refusal of the tax advantage. As a consequence, the tax advantage should be granted to third country residents as well.

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Norway – EFTA Court judgment on Norwegian tax rules on maximum credit allowance: Seabrokers case (E-7/07)

Seabrokers AS is a Norwegian limited liability company which operates a real estate business in Norway. The company has five Norwegian subsidiaries in the same segment and a branch (PE) in the UK which operates in the ship broking business. The branch rents its offices and is not involved in the group's real estate business. The Norwegian business activity is to develop and rent out office buildings which are financed by loans secured by mortgages on the properties. The UK branch on the other hand, only has debts related to operating expenses and thus minor interest costs. Hence, the two units are operated separately, both with regard to the nature and location of the business activities.

Norway has entered into a Double Tax Convention (DTC) with the UK. The DTC uses the credit method to avoid double taxation and the credit allowance is limited to ordinary credit. The Norwegian tax law and regulations have special provisions on how to calculate the credit allowance. Ordinary credit is equal to the lowest of actual taxes paid abroad and Norwegian tax derived from foreign source income. The latter is basically to multiply foreign source income with the general tax rate of 28 %. The disputed issues were the rules for computing foreign source income. In the regulation, there is a rule which allocates interest costs between foreign sourced and Norwegian sourced income based on a net income method (thus after direct cost and income is allocated). The same allocation method applies for group contribution which was the second issue in this case. The parties agreed that the allocation method resulted in more tax in total for a company with a PE abroad than for a company performing the same activity in Norway. The tax rules in question were clear. The question was whether the rules were in breach of Articles 4 (discrimination based on nationality), 31 (freedom of establishment) and 40 (free movement of capital) of the EEA Agreement.

The EFTA Court rendered its decision on 7 May 2008 and concluded that the Norwegian tax rules in question restricted the freedom of establishment (Article 31 EEA) in other EEA countries. Consequently, the other articles, 4 and 40, did not have to be considered.

The EFTA Court held that the allocation of interest expenses based on net income gave as a result additional tax for a Norwegian company with a foreign branch compared to a company

that performs all its activities in Norway. Since the interest expenses were related to debt of which the UK PE had very little, these regulations will allocate more than actual costs to the foreign source income than is economically justifiable. The effect is similar when the company only is entitled to a tax deduction for part of its interest expenses if it also performs business activities in another EEA country. In this respect, the method for calculating maximum credit may potentially result in an additional tax burden in Norway for the company as a consequence of its foreign activity and irrespectively of the taxation that takes place in the other country. This was seen as a measure which could hinder or make it less attractive to exercise the right of freedom of establishment. Norway did not put forward any reason for justifying the restriction. It should be noted that the parties disagreed whether there was a link or not. The Court held that it is for the national court to make the factual assessment.

The second issue before the court was group contributions. Distributed group contribution reduces foreign source and Norwegian income the same way as interest costs when calculating maximum credit allowance. The arguments presented to the EFTA Court were more or less the same as for interest expenses so the Court came to the same conclusion.

On 2 June 2008, the Norwegian tax authorities issued an information circular dealing with the consequences of the EFTA Court judgment in the Seabrokers AS case. The circular states that taxes levied the last three years in breach of the EEA Agreement in similar cases as Seabrokers' may be refunded. It is also expected that the said rules on allocation of interest expenses will be changed going forward (the rules on allocation of group contributions have already been changed with effect from 2007). There are ongoing court cases where the disputed point is whether there is a three year or ten year limit for filing EEA based refund claims and it is therefore questionable if the circular is correct on this point.

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EU DEVELOPMENTS

European Commission requests Denmark to change tax measures discriminating against income from foreign-based investment funds

On 26 June 2008, the European Commission announced that it has formally requested Denmark to change its tax provisions according to which income from investment funds is taxed at a preferential rate if the latter fulfils detailed requirements that are very difficult or impossible for foreign-based investment funds to fulfil. The Commission considers the provisions incompatible with the freedom to provide services and the free movement of capital as guaranteed by Articles 49 and 56 of the EC Treaty and Articles 36 and 40 of the EEA Agreement. The request takes the form of a Reasoned Opinion (second step of the infringement procedure provided for in Article 226 of the EC Treaty). If Denmark does not provide a satisfactory reaction to the reasoned opinion within two months, the Commission may decide to refer the matter to the ECJ.

Under Danish Law, income from investment funds can be taxed as capital gains or as income from shares. The taxation of capital gains is heavier than the taxation of income from shares income from investment funds that fulfil a number of detailed requirements. The funds respecting the prescribed requirements are allowed to benefit from the more advantageous tax treatment in the hands of the investor. However, the requirements are so strict, that effectively only Danish investment funds can fulfil them. As a result, Danish investors are discouraged from investing in investment funds based in other EU or EEA/EFTA States, as they will not be able to benefit from the more advantageous tax treatment. Based on the ECJ's earlier judgments in *Safir*, *Futura Participations SA*, *Singer* and *Stauffer*, the Commission opines that the Danish provisions impede the freedom to provide services and the free movement of capital as guaranteed respectively by Articles 49 and 56 of the EC Treaty and Articles 36 and 40 of the EEA Agreement. The Commission's case reference number is 2007/2002.

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European Commission formally requests the Czech Republic and Italy to end discriminatory taxation of foreign pension funds

On 6 May, the Commission announced that it has sent Reasoned Opinions to the Czech Republic and Italy demanding them to end their discriminatory taxation of foreign pension funds vis-à-vis domestic pension funds regarding outbound dividends. For the Czech Republic the Reasoned Opinion also concerns interest and real estate income.

Italy levies 11% substitute tax on dividends received by Italian pension funds, whereas dividends paid from Italy to non-resident pension funds established elsewhere may be subject to an Italian withholding tax at an effective rate of at least 15%.

The Czech Republic levies a withholding tax of 15 % on dividends paid both to domestic and foreign pension funds but domestic pension funds can either credit the withholding tax against corporation tax payable on other income (dividend income is not part of their corporate tax base), or they get a refund of the withholding tax. Pension funds established in other EU Member States or in the EEA/EFTA countries, however, cannot get a refund of the 15% withholding tax on the dividends paid to them. The result is that Czech pension funds are effectively exempt from dividend income whereas foreign pension funds pay 15 % withholding tax. In addition, Czech pension funds are not subject to a withholding tax on the interest they receive, nor is interest included in their tax base. Interest paid to foreign pension funds is subject to a withholding tax of 15%. Also, Czech pension funds pay a 5% tax on income from real estate, foreign funds pay 21%.

The higher tax on income from dividends, on interest and on real estate income, received by foreign pension funds may dissuade these funds from investing in the Member State levying the higher tax. Equally, companies established in these Member States may face difficulties in attracting capital from foreign pension funds. The higher taxation of foreign pension funds thus results in an unlawful restriction of the free movement of capital (Art. 56 EC and Art. 40 EEA). In the case of controlling participations by the foreign pension funds, it may also result in a restriction of the freedom of establishment, protected by Art. 43 EC and Art. 34 EEA.

Since May 2007, the Commission has sent Letters of Formal Notice to the Czech Republic, Denmark, Spain, Lithuania, the Netherlands, Poland, Portugal, Slovenia and Sweden (IP/07/616), Italy and Finland (IP/07/1152), Austria, and Germany and Estonia (IP/08/143), and it has sent reasoned opinions to Spain and Portugal on 6 May 2008 (IP/08/712). The Commission is still examining the situation in another Member State which may result in another infringement procedure. EU Tax Commissioner Kovács has called the elimination of tax discrimination against foreign pension funds a high priority for the Commission. The EC case reference numbers are 2006/4102 (Czech Rep.) and 2006/4094 (Italy).

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European Commission takes steps against Spain and Portugal regarding their discriminatory taxation of outbound dividends to foreign pension funds

On 6 May 2008, the European Commission announced that a Reasoned Opinion (the second step of the infringement procedure of Article 226 of the EC Treaty) has been sent to Spain and Portugal regarding their discriminatory taxation of outbound dividends paid to pension funds that are resident within the EU or the EEA.

The step now taken against Spain and Portugal follow the formal requests of information previously sent by the Commission in May 2007 as part of the first formal step of the infringement procedure (see EUDTG Newsalert NA 2007 – 015).

Under current Spanish legislation, Spanish pension funds are subject to zero-rate CIT on their income and can claim back any Spanish withholding tax on dividends that they receive. The domestic dividends received by the pension funds are thus effectively tax free. In contrast, dividends paid to pension funds established in the EU or in the EEA countries are subject to a withholding tax of 18% (though bilateral tax treaties may lead to a lower withholding tax). In the Commission's opinion, this situation is not compatible with the EC Treaty and with the EEA Agreement, as it is an infringement of the free movement of capital and, in the case of controlling participations held by foreign pension funds, may also result in a restriction of the freedom of establishment.

Similarly, Portugal exempts the dividends received by domestic pension funds and levies a withholding tax of 25% on dividends paid to pension funds based in other EU or EEA/EFTA States. The higher tax on dividends paid to foreign pension funds may dissuade these funds from investing in the Member State levying the higher tax. Equally, companies established in these Member States may face difficulties in attracting capital from foreign pension funds. The higher taxation of foreign pension funds results in a restriction of the free movement of capital (Article 56 EC and Article 40 EEA). In the case of a controlling participation by the foreign pension funds, it may also result in a restriction of the freedom of establishment, protected by Article 43 EC and Article 34 EEA.

As the formal requests are in the form of Reasoned Opinion, Spain and Portugal now have the opportunity to submit their observations. If both countries do not comply with the request

within two months, the Commission may refer them to the ECJ. If Spain and Portugal admit that their current domestic provisions concerning the taxation of outbound dividends to foreign pension funds are not compatible with the EC Treaty and amend their legislation accordingly, or if the cases go to the ECJ and the Court follows the Commission's views, this could lead to the refund of withholding taxes suffered by foreign pension funds on Spanish and Portuguese dividends.

The Commission's case reference numbers are: 2006/4106 for Spain and 2006/4104 for Portugal.

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European Commission requests Portugal to end discriminatory taxation against non-resident taxpayers (case 2006/5036)

On June 2008, the European Commission sent a formal request to Portugal to amend its tax legislation applicable to non-resident taxpayers.

According to Article 19 of the General Tax Law (*Lei Geral Tributária*), non-resident taxpayers who obtain income in Portugal subject to taxation must appoint a fiscal representative in order to represent them before the Portuguese tax authorities and to guarantee the fulfilment of their fiscal obligations.

The Commission considers that the difference of treatment applicable to non-residents, the obligation to appoint a fiscal representative, goes beyond what is necessary to guarantee payment of taxes and prevent tax evasion, and restricts the free movement of persons and the free movement of capital, foreseen in articles 18 and 56 of the EC Treaty and articles 36 and 40 of the EEA-Agreement.

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

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European Commission requests Bulgaria and Romania to end their discriminatory taxation of dividends to foreign companies and closes case against Luxembourg

On 6 May 2008, the European Commission announced that it has sent Letters of Formal Notice (the first step of the EU's Infringement Procedure under Article 226 of the EC Treaty) to Bulgaria regarding its rules under which inbound dividends paid to companies may be taxed more heavily than domestic dividends, and to Romania and Bulgaria regarding their rules under which outbound dividends paid to foreign companies may be taxed more heavily than domestic ones.

In Romania, domestic dividends on participations of up to 15% of the shares are subject to a final withholding tax of 10%. On similar outbound dividends, Romania levies a withholding tax

of 16%. Bilateral tax treaties may reduce that rate. Domestic dividends on participations of 15% or more are tax exempt. In contrast, Romania levies a final withholding tax of 10% on dividends paid to companies resident in Norway and of 16% on similar outbound dividends paid to companies resident in the other EEA/EFTA countries.

Bulgaria exempts domestic dividends from withholding tax or corporation tax. However, outbound dividends paid to companies resident in the EU with a shareholding of less than 15% are subject to a withholding tax of 5% (if the shareholding is 15% or more they are exempt). Outbound dividends paid to companies in the EEA/EFTA States are also subject to a withholding tax of 5%, regardless of the size of their shareholding.

According to the Commission, the higher taxation of outbound dividends paid to companies may result in a restriction of the free movement of capital (Article 56 EC and Article 40 EEA). Similarly, in the case of controlling participations by the foreign companies, it may result in a restriction of the freedom of establishment (Article 43 EC and Article 34 EEA).

Concerning the higher taxation of dividends paid to companies the Commission has already decided to refer Belgium, Spain, Italy, the Netherlands and Portugal to the ECJ on 22 January 2007 (see IP/07/66). The Commission has sent Reasoned Opinions to Luxembourg (see IP/06/1060 of 25 July 2006), Germany and Austria (see IP/07/1152 of 23 July 2007) and Lithuania (see IP/08/334 of 28 February 2008). The Commission sent a letter of formal notice to the Czech Republic (see IP/08/143 of 31 January 2008). The Commission closed the infringement procedure against Latvia in January 2008, and, as announced on 6 May 2008, also the procedure against Luxembourg.

The Commission's case reference numbers are 2007/4883 (inbound dividends) and 2007/4333 (outbound dividends) for Bulgaria and (2008/2048) for Romania.

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CCCTB - common consolidated corporate tax base

On 12 June 2008, the Irish electorate rejected the Treaty of Lisbon. Despite this result EU leaders are vowing to press ahead with ratifying the treaty although the Lisbon Treaty officially needs the approval of all 27 EU Member States.

In an interview printed in the Financial Times on 19 June 2008, the French Finance minister, Christine Lagarde said that the proposal for a CCCTB has not been abandoned but Paris will no longer press other governments to back it over the next six months. A similar view is taken by Marie-Christine Lepetit, director of fiscal legislation at the French Ministry of Finance.

Despite the comments of Christine Lagarde it is understood that EU Tax Commissioner Lazslo Kovacs may still present proposals for a CCCTB during the French Presidency of the EU. Mr Kovacs confirmed that an impact assessment of the proposal is currently being finalised.

Marie-Christine Lepetit indicated that France will try to get all 27 members to agree to the proposal rather than pursue enhanced cooperation among a group of EU Member States.

As regards the CCCTB itself, it is understood that France wants the CCCTB to be unanimous and mandatory, that it wants to conform the domestic base to the CCCTB base and still to have individual assets rather than pooling.

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STATE AID

Italy – European Commission opens a formal State aid investigation into 300 million Euro granted by the Italian State to Alitalia

With its decision dated 11 June 2008, the European Commission opened a formal investigation procedure into a loan to Alitalia through Italian State resources in order to ascertain whether it is compatible with the EC Treaty rules on State aid.

Alitalia is a joint-stock company operating in the air transport sector, with its shares listed on the Milan Stock exchange. The main shareholder of the company is the Italian State, holding a participation equal to 49,9% of the company's shares. Alitalia is in a difficult financial and economic situation and is investigating its possible privatization.

By means of the Decree Law dated 23 April 2008, no. 80 (converted into Law dated 23 June 2008, no. 111), the Italian government granted a loan of 300 million Euro to Alitalia in order to enable it to deal with its current payments. A second Decree Law dated 27 May 2008, no. 93 allowed Alitalia to use that sum for covering its losses and maintaining the value of its capital so as to avoid insolvency proceedings and allow its possible privatization.

Several companies, including competing airlines filed complaints with the Commission against the Italian measures. On the basis of the information submitted by the Italian authorities and of the mentioned complaints, the Commission decided to open the formal investigation procedure via Article 88 EC considering a preliminary assessment that the measures in question may constitute a State aid incompatible with the Internal Market. The Commission will also examine the exact nature of the measures enacted by the Italian Government and the conditions under which the aid has been granted to Alitalia so as to determine if it constitutes a State aid within the meaning of Article 87 EC. In this context, the Commission will also assess if a private investor, acting under the normal market conditions, would have acted in the same way as the Italian government.

Alitalia had already benefited from restructuring aid in 2001 and rescue aid in 2004. Under the Commission's Guidelines on State aid for rescuing and restructuring firms in difficulty, rescue aid and/or restructuring aid may be granted to a company only once during a 10-year period. This principle is known as the "one time, last time" principle and aims at excluding repeated interventions of a Member State in favour of one company. Based on this principle, Italy is not allowed to grant to Alitalia the aid provided for by the mentioned Law Decrees.

All interested parties can submit their comments. The preliminary assessment made by the Commission in this first step of the procedure does not prejudge the final decision that the Commission will issue. The investigation procedure could take up to 18 months.

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Italy – Commission opens a formal State aid investigation into the Italian tax relief measures in favour of cooperatives operating in the banking, retail and distribution services sectors

On 17 June 2008, the European Commission announced that it has opened a formal investigation procedure under EC Treaty State aid rules into the Italian tax relief measures in favour of the cooperatives operating in the retail, distribution and banking sectors in Italy.

The main tax measures under review are:

- the exemption from taxation of the profits allocated to non-distributable reserves;
- the exclusion from the corporate taxable income of the sums (so-called "ristorni") distributed to the stockholders in the form of partial restitution of the amounts they paid for the purchase of the goods produced or the services rendered by the same cooperative;
- under certain conditions, the deduction from the regional business activity taxable base (IRAP taxable base) of the interest paid to the stockholders for the loans or the deposits they granted to the cooperative.

The tax measures in question were granted by the Italian State to cooperatives of all sizes and sectors. Starting from 2004, after the reform of the Italian company law (brought by the Legislative Decree dated 17 January 2003, no. 6) which made a clear distinction among the cooperatives on the basis of importance they gave to mutuality, these tax measures only apply, with some adjustments, to the mainly mutual cooperatives, i.e. in the case of cooperatives:

- carrying out their business mainly in favour of their stockholders, who are the final consumers of their goods and services;
- mainly using, for the carrying out of their business, the working activity of their stockholders;
- mainly using, for the carrying out of their business, the services and goods contributed by their stockholders.

After receiving several complaints, the Commission decided to start a formal review under the EC Treaty rules on State aid of the mentioned tax measures. According to the Commission, the assessment must be made in the light of the valuable contribution of the cooperatives to the economy and to the society at large. The Commission also pointed out that cooperatives have certain specific features as they operate in the interest of their stockholders and have a specific corporate model. Therefore, cooperatives can be distinguished from profit-making companies, especially when they are purely mutual and exclusively generate revenues from

the selling of their goods or the rendering of their services to the stockholders. However, the Commission considered that these tax measures may constitute a State aid where:

- they also apply to cooperatives acting as profit-making companies in the market (e.g. non-prevalently mutual cooperatives);
- they also apply to the profits made by prevalently mutual cooperative from transactions with third parties; or
- they are not linked to the participation of the stockholders to the activity of the cooperative as such.

More precisely, at this preliminary stage the Commission considered that:

- the exemption from taxation of the profits allocated to non-distributable reserves:
    - in the case of mainly mutual cooperatives, may constitute a State aid with reference to the profits corresponding to revenues generated from transactions with third parties;
    - in the case of non-prevalently mutual cooperatives, has always to be considered as a State aid (with the only exception of the profits allocated to obligatory indivisible reserves) because these companies operate as profit-making companies, since the stockholders are not really involved in the cooperatives' business activity;
- the exclusion from the corporate taxable income of the sums distributed to the stockholders would appear not to be a State aid, as these sums are generated only from exchanges between stockholders;
- the deduction from the regional business activity taxable base (IRAP taxable base) of the interest paid to the stockholders for the loans or the deposits they granted to the cooperative, may be considered as a State aid because the granting of a loan from stockholders does not fall within the activities they perform in their capacity of stockholder. In fact, in this case the stockholders act as third party lenders as they are not sharing economic risks with the cooperative. Therefore, a preferential tax regime cannot be justified.

The preliminary assessments made by the Commission in this first step of the procedure do not prejudge the final decision that the Commission will issue. The Italian Authorities and all interested parties have the right to submit their comments.

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Italy – ECJ referrals on the Italian tax relief measures granted to cooperatives

On 25 February 2008 the Italian Supreme Court ("Corte Suprema di Cassazione") filed with the ECJ three references for a preliminary ruling concerning the classification as State aid of the tax relief measures granted by the Italian State to mainly mutual cooperatives.

The tax measures in question, provided for by the Presidential Decree no. 601 of 1973 in favour of the mentioned cooperatives, are:

- the partial exemption from taxation of the profits produced (sections 10 and 11);
- the exclusion from the corporate taxable income of the sums (so-called "ristorni") distributed to the stockholders in the form of partial restitution of the amounts they paid for the purchase of the goods produced or the services rendered by the same cooperative (section 12);
- under certain conditions, the deduction from the regional business activity taxable base (IRAP taxable base) of the interest paid to the stockholders for the loans or the deposits they granted to the cooperative (section 13).

The Corte the Cassazione, in all three references, asked whether:

- the tax relief measures in question are compatible with the Community rules on competition and, more precisely, if they can be considered as State aids within the meaning of Article 87 of EC Treaty;
- for the purposes of assessing if they can be considered as State aids, these measures can be regarded as proportionate in relation to the objectives pursued by the cooperatives, both in the case they are separately taken into account and in the case they are considered as a whole;
- regardless of whether these measures can be considered as State aids, the use of the legal form of the cooperative, also outside the cases involving fraud or deception, can be considered as an "*abuse of law*" if that legal form is used with the only purpose of achieving a tax saving.

The requests for a preliminary ruling are related to the following cases: *Agenzia delle Entrate vs Paint Graphos S.c.a.r.l.* case (C-78/08), *Adige Carni S.c.r.l. vs Agenzia delle Entrate* case (C-79/08) and *Ministero delle Finanze vs Michele Franchetto* case (C-80/08).

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Spain – AG Opinion on Basque tax measures and classification as State aid in the UGT Rioja Case (joined cases C-428/06, C-429/06, C-430/06, C-431/06, C-432/06, C-433/06 and C-434/06)

The Basque tax regime, which foresees reduced corporate tax rates and other kinds of tax incentives for entities having their tax residence in the Basque Provinces (Álava, Guipúzcoa and Biscay), has been examined in order to clarify if the tax measures within the regime can or can not be classified as illegal State aid under article 87 (1) EC. This examination results from the actions brought by two Spanish regions neighbouring the Basque region (Rioja and Castile and Leon) and the UGT Workers Union of Rioja before the Basque Regional Court, which requested the ECJ for preliminary rulings (joined cases referred above).

In general terms, a measures is considered as illegal State aid if the measure provides a selective advantage, i.e., if it favours certain undertakings or the production of certain goods in comparison with other undertakings which are in the same legal and factual situation. Therefore, when it is a question of analysing if a measure is selective in character, the determination of the reference framework (base for comparison) is essential.

AG Kokott dealing with the preliminary ruling in the UGT – Rioja case, on 8 May 2008 concluded that the ECJ should follow the *Azores* case-law (C-88/03), from September 2006, and consider that if the Basque Provinces have sufficiently autonomous powers in relation to the central power, the legal framework appropriate to determine the selectivity of the tax measures should be then limited to the regional legal system. If so, the Basque tax measures should not be considered illegal State aid since they are not selective when compared to the regional legal system (they are applicable to all entities that fall within the scope of the Basque tax regime).

AG Kokott also concluded that, in order to define if a tax measure has been adopted in the exercise of sufficiently autonomous power, the following requirements should be met:

- the measure must have been taken by a regional or local authority which has, from a constitutional point of view, a political and administrative autonomy from the central government;
- it has been adopted without the central government being able to directly intervene as regards its contents or its procedures;
- the financial consequences of more favourable tax measures in the region must not be offset by aid or subsidies from other regions or central government.

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The EUDTG is one of PricewaterhouseCoopers' Thought Leadership Initiatives and part of the International Tax Services Network. The EUDTG is a pan-European network of EU tax law experts and provides assistance to organizations, companies and private persons to help them to fully benefit from their rights under EC Law. The activities of the EUDTG include organising tailor-made client conferences and seminars, performing EU tax due diligence on clients' tax positions, assisting clients with their (legal) actions against tax authorities and litigation before local courts and the ECJ. EUDTG client serving teams are in place in all 27 EU Member States, most of the EFTA countries and Switzerland. See the EUDTG website for more information: www.pwc.com/eudirecttax.

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