

# EU Tax News

 ERNST & YOUNG

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A bi-monthly review of  
EU taxation developments  
affecting business in Europe

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## Editorial

In the field of indirect taxation, the European Court of Justice (ECJ) started the year with a series of VAT cases. While the Opinion of an Advocate General usually indicates the final outcome, we must await ECJ judgments on cases dealing with, for example, refunds and investment funds. Several governments are combating fraud in taxation and carousel trade, while the Commission has launched a public consultation on how to eliminate double taxation of VAT.

The ECJ judgment in the Meilicke case confirmed earlier verdicts on dividend taxation. This Newsletter also covers the debate between the EU and Switzerland on State aid, as well as important developments in several Member States.

EU political debates have found common ground on the importance of budget deficits and the role that taxation can play. Further to recently published reports, Europe's leaders have been discussing energy supply and efficiency as well as climate change. Ensuing policies will probably lead to a renewed focus on fiscal measures.

*Matthias Roche*

## Major Developments

### Transfer Pricing

*The Commission has issued guidelines on Advance Pricing Agreements (APAs), based on consultation with the EU Joint Transfer Pricing Forum.*

APAs are agreements between the tax administrations of EU Member States which define how and where future transactions between related taxpayers established in two or more Member States will be taxed. The Commission has now drafted guidelines for APAs, which will make it easier for companies to avoid some of the problems caused by different transfer pricing rules in Member States. Transfer pricing rules aim at ensuring that, in cross-border situations, related companies allocate the correct tax base to the countries where they trade. All parties gain considerable certainty from APAs and can save significant time and resources. The Commission guidelines set out a broad framework for APAs and give examples that show how some specific problems can be resolved. The aim is to speed up and improve the efficiency of APAs in the EU in order to reduce the likelihood of disputes and double taxation.

## Switzerland – State Aid

*On 13 February 2007, the European Commission and Switzerland issued statements regarding the sustainability of certain Swiss cantonal tax regimes. The Commission argues that the Swiss regimes constitute illegal State aid. The Swiss Government disagrees. Taxpayers will need to keep an eye on further developments in this unresolved argument, which is bound to last a number of years.*

### Cantonal Tax Regimes under Scrutiny

Since September 2005, the European Commission has considered the cantonal tax relief applying to “holding companies,” “auxiliary companies,” and “mixed companies” as illegal State aid under the 1972 Swiss-EC Free Trade Agreement (FTA).

Under Swiss law, the cantons may fully or partially exempt profits generated abroad from cantonal and municipal company tax. Over the years, this has proved to be an attractive way for multinational companies to minimise their tax liabilities by basing their headquarters, co-ordination and distribution centres in certain cantons. The Commission argues that such regimes affect trade between the EU and Switzerland, and thereby undermine the common market principle of a level playing field.

Auxiliary and mixed companies undertake mainly administrative or ancillary activities in Switzerland. Whereas auxiliary companies may not be engaged in any commercial activities in Switzerland, mixed companies are primarily engaged in commercial activities abroad. Although their Swiss-source income is subject to full taxation, they are taxed at significantly reduced rates on their foreign-source income, such as income from commercial transactions where the goods are purchased and sold abroad. Qualifying holding companies can benefit from a full tax exemption from cantonal corporate income tax in order to avoid multiple levels of taxation of dividend flows.

### Commission Decision and Swiss Response

In the past, the OECD gave a clean bill of health to all Swiss tax regimes. However, in September 2006, the Commission increased the political pressure on Switzerland and, on 13 February 2007, unilaterally and formally stated that the

aforementioned regimes are incompatible with the FTA and asked Switzerland to withdraw or substantially amend them. The Commission decision has used the format of the other Commission decisions on State aid cases for EU Member States (e.g., Austria). However, Switzerland is not an EU Member State, so this decision has no binding effect. The Commission has based its decision on Article 23 of the FTA, which is similar to the core State aid disposition within the EC Treaty of Rome as amended (Article 87). Regarding the scope of the FTA, the Swiss authorities maintain that the agreement is not applicable since it only covers certain designated goods.

The Commission argues that the Swiss regime constitutes illegal State aid because:

- it provides disproportionate advantages;
- such advantages are granted out of state resources;
- the advantages specifically benefit certain enterprises or the production of certain goods;
- they affect competition and trade rules.

The Commission also bases its evaluation of tax regimes on the 1997 Code of Conduct for Business Taxation.

If Switzerland fails to respond, the EU has threatened to impose countervailing customs duties on goods purportedly subsidised by the Swiss tax regimes.

### Analysis

The Swiss Federal Government has rejected the European Commission’s arguments as to (1) the applicability or relevance of EU State aid rules, (2) the selectivity of the targeted regimes and (3) their impact on trade.

### *Applicability of EU rules*

The rules and means of interpretation of international treaties are contained in the 1969 Vienna Convention on the Law of Treaties (VCLT), which in its Article 31(1) sets out the general principle that “a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose”.

Clearly, the purpose of a free trade agreement is much narrower than that of the EC Treaty, which pursues complete integration of the Member State economies in a unified common market through harmonisation of entire areas of law. Article 2 of the FTA further limits the application of the agreement to EC-origin or Swiss-origin products listed in designated sections of the harmonised system for designation and codification of goods, or in Annex II or in Protocol No. 2 to the FTA.

*Selectivity of Swiss regimes*

The Commission claims that the targeted regimes are selective, i.e., they favour certain undertakings or the production of certain goods, in the sense that these are available only to companies fulfilling certain criteria regarding activity or assets. This is in line with the horizontal and objective approach adopted by the EU on tax relief. From an EU angle, non-selective exemptions are essentially exemptions available to all taxpayers based on objective criteria attaching, for example, to the type of income earned, as opposed to subjective exemptions based on criteria attaching to the taxpayer. The advantages resulting from the use of a properly structured holding company are comparable in Switzerland and in numerous EU jurisdictions.

However, the criteria set out in Swiss law are broad and based solely on the nature or territoriality of the activity carried out. Any taxpayer (regardless of nationality, production or nature of business), having eligible activities and assets, can set up a separate corporate entity and transfer those activities or assets to it in order to meet the relevant criteria (such as the two-thirds test applicable to holding companies).

*Impact on trade*

The Commission claims that the Swiss tax regimes have an impact on Swiss-EC trade or even favour exporters, even though cantonal tax advantages for auxiliary and mixed companies only apply to goods purchased and sold outside Switzerland. The Commission is of the view that the regimes influence “existing cross-border trade patterns concerning third-country origin products sold on the common market via the establishment of special-purpose intermediaries” in Switzerland.

However, the location of an intermediary in Switzerland does not turn each transaction it performs into an export from Switzerland, as long as the goods sold are not of Swiss origin and neither enter nor exit Swiss territory. Besides, the same special-purpose intermediaries can be (and are) used the other way round, i.e., to export EC-origin products to third countries.

Holding companies in Switzerland are prohibited from engaging in any commercial activity. The Commission has concluded that “such holding companies must necessarily belong to economic groups directly engaged in business activities within and/or outside Switzerland” so that they “may affect trade...in all cases where the groups carry out an economic activity involving trade in goods”. Due to the lack of factual evidence, this does not demonstrate any actual

economic impact and would be equally applicable to EU-based special-purpose holding companies.

**Next Steps**

The imposition of countervailing duties seems unlikely as:

- it would need to be proportionate and targeted, which would require precise identification of the affected goods;
- these goods come from third countries which would be disadvantaged by such duties;
- such duties would harm the economies of both importer and exporter, due to the reduction in trade flows.

These factors explain the considerable restraint exercised in the past by the EU in tax subsidy cases (e.g., US Foreign Sales Corporations), when it comes to actually applying duties.

Based on the decision, the Commission wants to start a political negotiation process with Switzerland. On the Swiss Government’s side, preparations are being made to show that similar tax privileges may exist within the legislative framework of EU Member States.

It should also be noted that Swiss tax rules are governed by 26 cantonal laws. The Swiss constitution explicitly gives the cantons autonomy to levy taxes and to legislate. In other words, the federal government has no mandate to negotiate on behalf of the cantons. Even a change in federal tax laws, such as the tax harmonisation law, may be a time-consuming process since it would require parliamentary discussions and is subject to a national referendum. In addition, one of the cornerstones of Swiss law is the principle of mutual trust, under which changes in tax law need to be announced well in advance, and “old regimes” are usually grandfathered for a certain period of time.

Even if changes in the tax laws were made, the legislative implementation of such changes would take quite a few years. At this stage, taxpayers looking at or already taking advantage of the beneficial treatment offered by Swiss holding companies, auxiliary companies and mixed companies should not take any immediate action in this respect. Nevertheless, it is wise to keep a close watch on developments regarding this important issue.

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## Direct Tax

### Country Updates

*A summary of direct tax developments, provided by local specialists in our European Tax Competency Group.*

#### BELGIUM

##### Outbound Dividends

On 25 July 2006, the European Commission formally requested Belgium to amend its tax legislation concerning outbound dividend payments to companies. Under Belgian domestic law, Belgian withholding taxes on dividends are creditable and/or refundable to a Belgian receiving company but not to a foreign receiving company. Consequently, dividend payments to foreign companies are more heavily taxed in Belgium than dividend payments to domestic companies. The Commission considers these rules restrict both the free movement of capital and the freedom of establishment. Since Belgium did not reply to its request, the Commission decided to refer Belgium to the ECJ. The Commission has indicated that the *Denkavit* (C-170/05) decision of 14 December 2006 will be taken into account when applying to the ECJ.

##### Inbound Dividends

In a parallel development on 20 July 2006, the European Commission formally requested Belgium to end the discriminatory taxation of dividends paid by foreign companies (inbound dividends) to Belgian private investors. Under the Belgian tax system, Belgian private investors who receive a domestic dividend are subject to a special income tax rate of, in principle, 25%. This tax is levied via a final withholding tax or a declaration of the dividend income in the tax return. Inbound dividends are often first subject to a withholding tax in the source State on the basis of the Double Taxation Treaty (DTT) between Belgium and that State, and subsequently suffer Belgian income tax at the special income tax rate of 25%. Since the tax credit for foreign withholding tax on dividends has been abolished under Belgian domestic law, inbound dividends are often taxed more heavily than domestic dividends. The Commission considers that this difference in treatment is contrary to the freedom of establishment and the free movement of capital, guaranteed by the EC Treaty. Note, however, that the ECJ, on 14 November 2006, opined in the *Kerckhaert-Morres* case (C-513/04) that Belgium is not

required under the EC Treaty to relieve juridical double taxation arising from disparities between different tax systems. Nonetheless, the Commission decided to refer Belgium to the ECJ as Belgium gave a negative answer to its request.

##### Deductions for Residents with Foreign Source Income

On 20 July 2006, the European Commission challenged the Belgian “exemption with progression method” via a formal request. If a Belgian resident individual receives both foreign and Belgian income, Belgium provides for an exemption of the foreign income based upon the applicable DTT. However, Belgium still takes this foreign income into account for the determination of the tax rate applicable to the Belgian source income. This method results in a limited deduction of personal and family allowances. Based upon the *De Groot* case (C-385/00), the Commission considers that this limited deduction of personal allowances is contrary to Articles 18, 39 and 43 of the EC Treaty. Since Belgium has not changed its legislation despite this request, the Commission has referred Belgium to the ECJ.

##### Discrimination in Flemish Real Estate Transfer Tax

According to the Flemish registration tax law, a taxpayer may deduct from the real estate transfer tax on the purchase of a house in Flanders (the northern part of Belgium) the amount of the real estate transfer tax paid earlier on another house, provided it was in Flanders. Since the European Commission believes the above mentioned condition is contrary to Articles 18, 43 and 56 of the EC Treaty, Belgium received a formal request on 20 July 2006 to end the discrimination in the Flemish real estate transfer tax. The Commission pointed out that the regional governments of the EU Member States are bound by the EC Treaty in the same manner as central governments. However, Belgium is of the opinion that residents and non-residents are not in comparable situations. Therefore, Belgium did not amend its legislation. As a result, the Commission has referred Belgium to the ECJ.

##### Inheritance Tax Exemption for Family Companies

On 15 February 2007, Advocate General (AG) Kokott delivered her opinion in the case of *Maria Geurts and Dennis Vogten v Belgian State* (C-464/05), dealing with inheritance tax. In the Flemish region, shares in a family company or claims against such a company are exempt from inheritance tax if that company has employed at least five workers in the three years prior to the death of the deceased and the heirs have continued to employ those workers for five years

subsequently. However, this exemption is restricted to cases where these workers have been employed in the region in question. According to the AG, this is contrary to the freedom of establishment of Article 43 of the EC Treaty.

#### **Discriminatory Tax Treatment of Houses outside Belgium**

Under Belgian domestic law, tax relief is granted for mortgage interest, capital repayment on a mortgage loan and contributions paid on a life insurance contract concluded with respect to such mortgage loan in relation to owner-occupied houses. For secondary houses, tax relief is granted for the payment of a mortgage loan. However, such tax relief is only granted if the owner-occupied and/or secondary houses are located in Belgium. Taking into account the *Schumacker* case (C-279/93), the Commission thinks these rules infringe Articles 39, 43 and 56 of the EC Treaty and, accordingly, has made a formal request for Belgium to amend its legislation.

#### **Minimum Tax Base for Non-residents**

Under Belgian tax law, a foreign undertaking that cannot present proper evidence to substantiate its taxable income earned in Belgium is subject to a minimum tax base depending upon the activities performed. In the *Raffaele Talotta v Belgium* case (C-383/05), Talotta claimed that these Belgian rules infringe the freedom of establishment. Talotta, a Luxembourg resident, operates a restaurant in Belgium as a self-employed person. Therefore, he is subject to the income tax for non-residents. Since he could not present the minimum documentation required to verify the exact amount of taxable income, the tax authorities applied a minimum tax base.

On 28 January 2007, AG Mengozzi gave his opinion in favour of Talotta. According to the AG, Belgian domestic law violates the freedom of establishment as laid down in Article 43 of the EC Treaty, since non-resident taxpayers can encounter a higher tax burden than resident taxpayers. According to the AG, the difference in treatment is not based upon objective differences, since the difficulty in obtaining the information needed to determine a taxpayer's taxable income is not linked to the taxpayer's place of residence. With respect to Belgium's argument that the measure is needed to guarantee the effectiveness of tax controls, the AG opined that such justification is not laid down in Article 46 of the EC Treaty and thus cannot be upheld. In anticipation of the outcome of this case, Belgium has extended the minimum tax base to resident taxpayers, but only if they do not file their tax return within the specified time limit.

## **DENMARK**

### **Corporate Tax Reform Proposals**

The Danish Minister of Taxation has introduced a draft bill to change fundamental principles in Danish corporate tax legislation. A primary purpose of the bill is to adjust the law on Controlled Foreign Companies (CFCs) to comply with EU law. The current Danish rules are, in principle, similar to the UK rules which were considered by the ECJ in the *Cadbury-Schweppes* case (C-196/04). The Danish Government proposes to abolish the rule which stipulates that only companies in low-taxed countries may be subject to the CFC regime. In future, all subsidiaries, Danish or foreign, will be covered by the Danish CFC legislation.

Amendments to the rules concerning interest deductions are also proposed whereby interest exceeding DKK 10 million may be restricted. Interest expenses in a range between DKK 10 million and an amount resulting from a special "asset test" will be deductible, subject to a 55% cap. Interest expenses above the amount resulting from the asset test will not be deductible at all.

The asset test is a fundamental new test which provides that a Danish company may only deduct interest costs up to a special normal return on the taxable value of the company's assets. The asset test is calculated as 6.5% of the company's relevant assets. The relevant assets are, in general, restricted to the company's assets located in Denmark. For example, if a Danish company incurs DKK 18 million interest in the taxable year and the company has relevant assets with a tax value of DKK 200 million, the Danish company may deduct 100% of the first DKK 10 million in interest but only 55% of the next DKK 3 million, based on the asset test cap of DKK 13 million (6.5% of DKK 200 million). The interest that exceeds DKK 13 million will not be deductible.

It is doubtful whether all aspects of the proposed tax reform bill are compatible with EU law and with the *Cadbury-Schweppes* case. For example, the interest deduction rules may be considered a violation of the freedom of establishment.

### **Pension and Life Assurance Contributions**

On 30 January 2007, in the case of *Commission v Denmark* (C-150/04), the ECJ ruled that the Danish life assurance and pension scheme system did not comply with EU law. Under Danish rules, only payments made to pension funds

established in Denmark are deductible or tax exempt. The Danish Minister of Taxation has stated that a bill to amend the Danish rules will be introduced soon.

### **AG Opinion – EC Merger Directive**

In the *Kofoed* case (C-321/05), the ECJ was asked to consider Danish tax practice in relation to the EC Merger Directive (90/434/EEC). The issue was whether the Danish tax authorities could treat a distribution of profits, which is closely connected with a cross-border exchange of shares effected shortly beforehand, as partial consideration and thus as a cash payment made by the acquiring company in exchange for the shares it has acquired. AG Kokott found that profit distributions effected by an acquiring company are not included in the concept of a cash payment within the meaning of the Merger Directive if the distribution was not agreed in a binding manner as consideration for the holding. This applies even if those payments were planned by the parties from the outset and were effected at a time closely connected to the acquisition of that holding. On this basis, Danish tax practice was not considered to comply with the Directive. If the ECJ reaches the same conclusion as the AG, it is likely to have a material impact on Danish tax practice.

### **Tonnage Tax**

The Danish authorities propose to end the requirement for companies benefiting from the tonnage tax scheme to submit financial information about their transactions with foreign subsidiaries and have requested the Commission to approve this change to the current scheme. However, the Commission takes the view that the change could reverse one of the control measures linked to the scheme, namely the monitoring of commercial transactions between companies subject to this scheme and their subsidiaries. Therefore, the Commission has decided to open a formal investigation of the proposed measure.

## **FRANCE**

### **French-sourced Dividends and Swiss Parent Companies**

The French and Swiss tax authorities have agreed to amend the anti-abuse provisions set out in the France-Switzerland DTT in respect of the exemption of French-sourced dividends distributed to Swiss parent companies. The French tax authorities considered that these provisions are also applicable under Article 15 of the EU-Switzerland Savings Directive Agreement of 26 October 2004, especially the anti-abuse provision set out in Article 11(2)(b)(ii) of the DTT. Pursuant

to this Article, French-sourced dividends could not benefit from the tax exemption if the Swiss parent company, not listed on a stock exchange, is owned by shareholders not resident in Switzerland or in another EU Member State.

According to an exchange of notes published on 6 February 2007 in the French administrative guidelines 14 A-1-07, this provision no longer applies to Swiss parent companies whose participation in a French subsidiary exceeds 25%, if they can show that exemption from the dividend withholding tax is not the main purpose or one of the main purposes of the chain of participation. If these new rules apply under both the DTT and the EU-Switzerland Agreement, the tax treaty remains more favourable, since parent companies owning 10-25% may benefit from the exemption and no minimum holding period is required, whereas the Agreement requires a two-year holding period.

The new rules apply retroactively from 1 July 2005.

### **French Tax Code and Parent-Subsidiary Directive**

Pursuant to Article 216 of the French Tax Code, a company receiving dividends benefiting from the parent-subsidiary exemption must include in its corporate income tax base the lower of (i) 5% of the tax-exempt dividends received, and (ii) the amount of all the expenses incurred by the parent company for the fiscal year during which it received the dividends. Some companies have contested this limitation on the grounds of the Parent-Subsidiary Directive, arguing that the non-deductible portion should be limited to the amount of the expenses relating to the holding. However, according to the decision of the French Supreme Tax Court released on 17 January 2007, the limitation provided by Article 216 is not contrary to the Parent-Subsidiary Directive.

Furthermore, pursuant to Article 216, the tax credits attached to the tax-exempt dividends received must be taken into account in calculating the 5% portion. According to the ECJ, such a provision is not contrary to the freedom of establishment and free movement of capital set out in Articles 43 and 56 of the EC Treaty, since these principles do not prohibit France from treating French parent companies less favourably than EU ones and EU subsidiaries are not less favourably treated than French ones.

In respect of the Parent-Subsidiary Directive, the ECJ limits the compatibility issue to EU-sourced dividends, since

dividends distributed by subsidiaries located in non-EU countries are outside the scope of the Directive. Besides, according to the ECJ, there is no issue when the tax credits attached to the EU-sourced dividends can be entirely offset against the withholding tax due in case of a redistribution of the dividends by the parent company. Hence, the ECJ's answer to the preliminary question asked by the French Supreme Tax Court, i.e., whether or not taking into account the tax credits attached to the tax-exempt dividends when calculating the 5% non-deductible portion may be authorised under Article 7(2) of the Directive, is likely to have a limited impact.

#### **Participation Exemption Regime and EC Freedoms**

The French Lower Court ruled on 21 December 2006 that the special tax credit attached to French-sourced dividends (*avoir fiscal*) and the equalisation tax (*précompte mobilier*) were contrary to the free movement of capital. For French parent companies benefiting from the participation exemption regime, the *avoir fiscal* attached to French-sourced dividends could be offset against the equalisation tax due on the redistribution of exempt income. By contrast, since EU-sourced dividends did not benefit from the *avoir fiscal*, French parent companies receiving EU-sourced dividends could not offset it against the equalisation tax due.

Even if the *avoir fiscal* and the *précompte mobilier* were abolished by the French Finance Law for 2004, French companies have contested for previous years the payment of equalisation tax for EU-sourced dividends on the grounds of the EC freedoms and the Parent-Subsidiary Directive. In this much awaited decision, the Lower Administrative Court of Versailles ruled that the French regulations regarding the *avoir fiscal* and the *précompte mobilier* constituted a restriction to the free movement of capital set out in Article 56 of the EC Treaty. Considering the amounts at stake, an appeal against this decision by the French authorities is anticipated.

## **GERMANY**

#### **Meilicke – Tax Credit for Dividends**

On 6 March 2007, the ECJ gave its long awaited decision in the *Meilicke* case (C-292/04). In its facts and merits, the case resembles the Finnish case of *Manninen* (C-319/02).

The former German imputation system provided a tax credit for dividends from domestic companies. The taxpayer (both individuals and corporations) could deduct a percentage of the

corporation tax on dividends paid by German companies. This rule did not apply to dividends paid by companies established in other Member States.

Heinz Meilicke was resident in Germany and held shares in companies established in the Netherlands and Denmark. From 1995 to 1997 he received dividends from those shares. His heirs applied for a proportional tax credit for these dividends, but the application was rejected by the German tax authorities.

The ECJ held that the German provisions on the taxation of dividends are inconsistent with the EC Treaty. Such national legislation, under which a fully taxable shareholder is only entitled to a tax credit – calculated by reference to the corporation tax rate on distributed profits – if the dividend-paying company is a domestic company, is precluded by Articles 56 and 58 of the EC Treaty. Such rules could deter persons who are fully taxable in Germany from investing abroad and constitute an obstacle to foreign companies wishing to raise capital in Germany.

In addition, the ECJ did not impose a temporal limitation.

The ECJ's decision means that applications for a tax credit should be considered for the years before 2002.

In this context, it has to be taken into account that, according to the ECJ's ruling, the percentage of the tax credit should be calculated by reference to the effective tax rate on distributed profits calculated under the tax law of the Member State where the distributing company is domiciled.

#### **Business Tax Reform 2008**

The German Government has published the first technical draft describing the changes in the German tax system coming into force in 2008. If the reform is enacted, the combined corporate income and trade tax rate will be reduced by about 9%.

Compliance with EU law is one consideration. For example, the current thin capitalisation rules will be replaced by an annual cap of interest deduction, regardless of whether the interest is paid by related or third parties, domestic or foreign corporations or partnerships. Hence, unlike the current thin cap rules, the proposed regulations minimise the conflict with EU law since they apply to all taxpayers. Discrimination arises, however, from the exemption to this rule for German group (*Organschaft*) relief, which still applies only for domestic cases.

Furthermore, in the light of more detailed transfer pricing

rules, the proposed changes of documentation obligations might affect the EC Treaty freedoms of non-resident taxpayers. On the one hand, the existing documentation obligation, which is already assumed to be contrary to the fundamental freedoms, will be tightened. On the other hand, the possibility of estimating the tax base is enlarged to the benefit of the tax authorities. In particular, the obligation for non-residents to cooperate without having a domestic tax connection themselves, can be criticised.

Some further instruments would not be in line with EU principles. For example, the withholding tax relief on dividends is still disadvantageous for non-residents and some tax benefits depend on the investment of assets in domestic branches.

#### **Deductibility of Business Expenses**

The Portuguese company Centro Equestro de Leziria Grande Lda was subject to tax in Germany on its income from horse shows carried out in Germany. The German tax authorities denied the claimed deduction of eleven-fourteenths of general and economic costs, arguing that part of the costs were not directly related to the activities in Germany.

In the *Centro Equestre* case (C-345/04), the ECJ decided on 15 February 2007 that it is not contrary to the freedom of provision of services to make repayment of tax deducted at source in Germany subject to the condition that the claimed expenses have a direct economic connection to the respective income, as far as all costs inextricably related to that activity are considered, irrespective of the place and time of their accrual.

In addition, the ECJ stated that the national regulation that a repayment claim is only available if the respective expenses exceed half of the income is contrary to Article 49 of the EC Treaty, as it cannot be justified that a deduction of operating expenses, incurred by a non-resident taxpayer is subject to an additional condition that is not applicable to resident taxpayers. In the light of this decision, companies should look at whether or not all costs related to cross-border activities have so far been deducted.

#### **Capital Gains Taxation**

A request for a preliminary ruling in the *Groningen* case (C-436/06) concerns the interpretation of Article 56 of the EC Treaty in connection with Section 17 of the German Income Tax Act. The Lower Tax Court of Hamburg wants to know whether it is contrary to the free movement of capital that

profits from the sale of shares in non-resident companies in 2001 were taxable if the seller held, directly or indirectly, at least 1% of the share capital within the previous five years, whereas profits from the sale of shares in a resident company were taxable only if at least 10% of the share capital was held.

### **IRELAND**

#### **Cross-border Loss Relief**

Ireland's 2007 Finance Bill was published on 2 February 2007 and contains a number of EU-related measures. The most important of these is an extension of the group relief system to take account of the decision of the ECJ in the *Marks & Spencer* case (C-446/03). It is now proposed that certain "trapped" trading losses incurred by 75% subsidiaries of an Irish company that are resident in EEA States (excluding Liechtenstein) will be available for surrender to the Irish parent company. A "trapped loss" is a foreign loss that, under the laws of the other State, cannot be utilised in any accounting period of the non-resident surrendering company or indeed other companies located in that other State.

Provision is made for claims in later years where it can be demonstrated at that time that the losses cannot be utilised. In view of the relatively low rates of Irish corporation tax, Ireland is unlikely to be a primary destination for cross-border loss claims. This might explain why the Irish legislation is more straightforward than its UK counterpart. However, the vast majority of Irish companies operating in a cross-border context are unlikely to have too many 75% subsidiaries, making the inability to claim losses from 75% sister companies or parent companies a notable restriction.

#### **Other Measures**

On 17 October 2006, the European Commission announced that it had formally requested Ireland to end the discrimination against foreign charities in its tax code. The Finance Bill amends the tax code to facilitate tax relief for donations to educational bodies established in other EU Member States but falls well short of what is required to take account of the ECJ decision in the *Stauffer* case (C-386/04).

At the time of going to print, no account had been taken of the decision of the ECJ in the *Franked Investment Income* case (C-446/04). However, an amendment has been put forward to take account of European Commission concerns that aspects of the Irish patent royalty exemption contravene EC Treaty

rules regarding the freedom of provision of services.

Following the intervention of the European Commission, the current tax exemption for stallion stud fees will terminate on 31 July 2008. With effect from 1 August 2008, stallions are treated as stock in trade and income or gains deriving from stud fees (net of costs) will become fully liable to income tax or corporation tax as appropriate at normal rates. However, the Finance Bill proposes, subject to Commission approval, to allow stallion owners to write off the purchase costs of stallions over a four-year period.

### **Societas Europaea**

On 22 January 2007, Ireland introduced the regulations necessary to implement the Statute for a European company (SE). This follows the transposition into Irish law on 14 December 2006 of Council Directive No. 2001/86/EC of 8 October 2001, regarding employee involvement in such companies. The introduction of the SE coincides with a new Finance Bill measure that significantly improves the tax treatment of foreign branches.

## **ITALY**

### **Interest and Royalties Directive**

On 9 January 2007, the European Commission formally requested Italy to implement correctly the Interest and Royalties Directive 2003/49/EC of 3 June 2003 (IRD) on a common system of taxation applicable to interest and royalty payments made in Italy between associated companies of different Member States.

The Commission considered that the relevant Italian provisions, excluding from the benefit of the IRD interest or royalties accrued before 1 January 2004, are disproportionate and go beyond what is necessary to achieve their legitimate purpose (see *EU Tax News*, Issue 17).

The Italian Government has since complied with the Commission requirements via Article 3(2)(3) of Law Decree No. 10 of 15 February 2007, which is to be formally converted into law by 16 April 2007. Under the revised law, the cash basis replaces the accrual basis with retroactive effect, starting from 1 January 2004. This change opens the way for companies which suffered withholding tax before 1 January 2004 to submit an application to the tax authority for a refund.

## **MALTA**

### **Maltese Tax Reform**

The Maltese Government recently published a bill outlining proposed reforms to Malta's tax refund system. The proposals are presently being discussed in parliament and are expected to be passed with minimal modifications very soon. The amendments regime will come into force retrospectively with effect from 1 January 2007.

The present imputation system, whereby the tax paid by the company will essentially remain a prepaid tax on behalf of the shareholder's tax liability upon dividend distributions, will be retained, but a new refund system analogous to the old refund system will be introduced. Distributions of dividends will continue to trigger tax refunds of the tax paid by the distributing company.

No new ITCs (international trading companies registered in Malta which broadly limit their objectives to carrying on trading activities with persons outside Malta who are not resident in Malta) may be registered as from 1 January 2007. Existing ITCs will lose their status by 31 December 2010, but profits earned by such ITCs prior to 31 December 2010 will continue to be governed by the ITC refund mechanism up to 31 December 2014. Companies established prior to 31 December 2006 that derive dividends from participating holdings acquired before 1 January 2007 will continue to benefit from the full refund mechanism in terms of the old regime until 31 December 2010. Income derived from participating holdings and income derived from foreign sources after 1 January 2007 will be governed by a new tax refund system. A formal participation exemption will be introduced. Income derived from participating holdings and capital gains derived from the transfer of participating holdings will be taxed at 0%.

The application of the participation exemption will be subject to certain anti-abuse provisions. Income that could not be considered as income from a participating holding will be governed by a new refund system. Distributions of profits, which have not been derived from participating holdings, will be subject to a six-sevenths refund of the tax paid by the distributing company. Distributions of profits derived from passive interest or royalties will be subject to a five-sevenths refund of the tax paid by the distributing company. If a Maltese company elects to claim double taxation relief on its foreign

source income, any eventual tax refund would be limited to two-thirds of the tax paid by the company.

## NETHERLANDS

### Inheritance Tax

With its ruling of 12 January 2007, the Dutch Supreme Court decided to refer preliminary questions to the ECJ in a case concerning the Dutch inheritance tax due upon an inheritance of Dutch real estate by a taxpayer living in Italy. According to the last will of the deceased, the taxpayer was obliged to pay, on a proportionate basis, a sum of money representing part of the value of the Dutch real estate to his four children. Based on Dutch inheritance law, this obligation could not be deducted from the tax base, i.e., the value of the Dutch real estate inherited by the taxpayer. The Dutch Supreme Court has now asked the ECJ to decide whether or not this is compatible with the free movement of capital. Moreover, the court wants to know whether or not it is relevant that a credit for the Dutch inheritance tax is available in Italy.

### Group Interest Box Regime

Under the proposed Group Interest Box regime, upon request by the taxpayer, an effective tax rate of 5% is applicable to the aggregate balance of interest income and expenses on inter-company loans. The Dutch Government has reported the Group Interest Box to the European Commission, requesting it to confirm that the regime does not constitute State aid.

On 7 February 2007, the European Commission decided to investigate the Group Interest Box regime under the EC Treaty State aid rules, although this regime appears to be open to all companies. The opening of an in-depth investigation enables interested third parties to submit their comments on the proposed measures but does not prejudge the outcome of the inquiry. The Commission considers that only groups of companies (and not individual companies) may benefit from the Group Interest Box regime. Furthermore, the regime seems to be tax neutral for groups active in the Netherlands only and would be likely to attract only multinational groups of companies. On the other hand, the Commission decided not to raise objections to the proposed reduced tax rate for interest on short-term deposits, provided these deposits are aimed at acquiring at least 5% of the shares of a company. This latter measure would equally benefit all companies subject to Dutch corporate tax and would therefore be compatible with the Single Market.

### Patent Box Regime

Self-developed intellectual property (excluding trademarks and brands) that has been patented after 1 January 2007 can be allocated to a so-called Patent Box. Any income from such intellectual property is subject to an effective tax rate of 10%. The Dutch Government reported the Patent Box regime to the European Commission and initially requested it to confirm that the regime does not constitute State aid. However, taking into account the fact that similar regimes to stimulate Research and Development (R&D) have been introduced in Austria, France, Hungary, Ireland and Spain, without reporting these regimes to the Commission, the Dutch Government has decided to withdraw its request and to introduce the regime without the Commission's formal validation.

In a decree of 31 January 2007, the Dutch Minister of Finance announced that the Patent Box regime is retroactively effective as of 1 January 2007. In this respect the Netherlands' position is that the Patent Box regime does not constitute State aid since it is not limited to specific companies. In support of its position, the Dutch Government also points to recent statements of the European Commission promoting the more effective use of tax incentives in favour of R&D and adopting a new State aid Framework for Research, Development and Innovation. Moreover, Commission President José Manuel Barroso has advised the Netherlands to further stimulate Dutch investments in research and development.

## PORTUGAL

### Capital Duty

The Portuguese Supreme Administrative Court referred to the ECJ a question on whether Article 7(1) Council Directive 69/335/EEC (amended by Council Directive 85/303/EEC) regarding indirect taxes on the raising of capital should be interpreted as prohibiting Member States from reintroducing stamp duty on a transaction from which it was exempt under national law at the accession date (1 January 1986). According to the Portuguese law in force on 1 January 1986, increases in the capital of commercial companies, paid or contributed in cash, were exempt from stamp duty. The Act of Accession of Portugal and Spain only included in the Annex the relevant Spanish and Portuguese "capital companies". No derogation or a different deadline addressed the implementation in Portugal of Directive 69/335/EEC. However, Decree Law No. 322-B/2001, in force as from 1 January 2002, has reintroduced taxation on capital increases in commercial companies realised

by the contribution of assets of any kind. Based on the above, AG Sharpston has issued his opinion in the case of *Optimus Telecomunicações, S.A. v Fazenda Pública* (C-366/05), which can be summarised as follows.

The mandatory exemption of Article 7(1) of Directive 69/335/EEC (amended by Directive 85/303) must be interpreted as applicable to any transaction subject to capital duty under the Directive which, at 1 July 1984, was exempt or taxed at a rate of 0.5% or less of capital duty in the Member State concerned. Articles 7(1) and 10 of Directive 69/335/EEC prohibit Portugal from levying stamp duty by virtue of national legislation on capital increases by payments in cash, when, as at 1 July 1984, that transaction was subject to that duty but was exempt from it.

## SLOVAKIA

### Tax Security - Payments to EU Tax Residents

Under an amendment to the Slovak Income Tax Act effective from 1 January 2007, the obligation to withhold tax security from the payments made to permanent establishments of taxpayers resident in other EU Member States has been repealed. As a result, from 1 January 2007, payments to Slovak tax non-residents, who are residents of other EU Member States, are paid in full and no tax is withheld. This applies only to payments that are not subject to withholding tax.

### Implementation of Savings Directive

As from 1 January 2007, the implementation of the Savings Directive was removed from the Slovak Income Tax Act. As a result, it is very likely that the Slovak tax authorities may seek to tax interest payments made to natural persons resident in other EU Member States. The exemption of interest payments from taxation can still be achieved on the basis of a DTT, as long as the particular treaty stipulates a 0% limit on the taxation of interest payments.

## UNITED KINGDOM

### EU Group Relief Developments – Marks & Spencer Case

On 20 February 2007, the Court of Appeal gave its decision in the *Marks & Spencer* case (C-446/03), concerning the availability of cross-border group relief within the EU/EEA, following the ECJ's judgment in December 2005. The Court of Appeal upheld the High Court's decision of April 2006, though it appears to have expanded the window in which claimants can satisfy the ECJ's requirement that there must

be no possibility of the loss-making subsidiary obtaining future relief for its losses. The Court held that the "relevant time" for determining whether this requirement is satisfied is principally the time that the claim is made (rather than at the end of each accounting period as the UK revenue authorities have contended). It also indicated that the test could also be satisfied at any time until the end of the period within which the claimant is permitted to make its claim.

It should be noted that HM Revenue and Customs (HMRC) was refused leave to appeal the "relevant time" aspect of the judgment to the House of Lords. Unless the House of Lords agrees to a petition submitted by HMRC to hear an appeal, this issue now appears to be reaching finality. This also has potential ramifications for the legislative amendments to the group relief rules (introduced by the UK authorities in response to the ECJ's judgment). It has been suggested that these amendments are too restrictive to the extent they provide that the "relevant time" is the end of each accounting period, and the Court of Appeal's judgment supports this view. ■

## Indirect Tax

### Latest EU Developments

#### VAT: Double Taxation

*The Commission has launched an online consultation until 31 May 2007 to ascertain the views of the public and businesses on the possible introduction of a mechanism for eliminating double taxation in individual cases.*

The Commission examines two possible approaches: (1) removal of the obligation to pay the amount of VAT demanded a second time until the dispute giving rise to the double taxation has been resolved between the Member States concerned and (2) elimination of the double taxation itself by introducing a procedure for mutual agreement between the tax administrations of the various Member States concerned; if this procedure fails, the matter could be sent to arbitration.

#### VAT: Special Investment Funds

*The ECJ has released the opinion of AG Kokott in this referral from the VAT Tribunal in London.*

The case of *JP Morgan Claverhouse Investment Trust plc/The Association of Investment Trust Companies v Commissioners of HM Revenue & Customs* (C-263/05) concerns the exemption

of the management of special investment funds under Article 13(B)(d)6 (now Article 135.1(g) of Directive 2006/112/EC), in particular the scope afforded by the words “special investment funds” as defined by Member States to decide if different categories of funds may or may not benefit from the exemption. The particular issue in the UK is that the national law grants exemption to the management of Open-Ended Investment Companies and Authorised Unit Trusts but not to the management of Investment Trusts.

The argument advanced by the appellants (an investment trust and the body representing investment trusts) is that, as these investment entities compete in the small investor market, the different VAT treatments cannot be sustained under European law principles. AG Kokott has recommended that the Court should agree with the argument that the differentiation under UK law is flawed. If the ECJ agrees, the investment management industry could have substantial opportunities for making refund claims.

#### **VAT: Refunds**

*On 15 February 2007, AG Mengozzi gave his opinion in the case of Rizeni Letovehu Provozu UR SP v Bundesamt für Finanzen (C-35/05).*

The German Finance Ministry had asked whether Article 2(2) of the Thirteenth Directive is to be interpreted restrictively as meaning that the possibility thereby afforded the Member States for making refunds of VAT conditional on the grant by non-Member States of comparable advantages in regard to turnover taxes, does not refer to States which, as contracting parties to the General Agreement on Trade in Services (GATS) may rely on the “most-favoured nation” clause therein. The AG recommends that the answer is no.

#### **Exemption from Excise Duty on Change of Residence**

*On 25 January 2007, AG Kokott gave her opinion in the case of Georgios Alevizos v Ipourgos Ikonomikon (C-392/05).*

The case concerns exemption under Directive 83/183/EC from excise duty and other consumption taxes on the importation of an individual’s personal property from another Member State when that importation is accompanied by the transfer of that individual’s normal residence from another Member State to the Member State of importation. The case concerned a member of the Greek armed forces who was posted to NATO’s base in Naples and spent several years living with his family in Italy. He bought a car which he took back to Greece at the end of his assignment.

AG Kokott concluded that there was no restriction of freedom of movement in this case and the exemption did not apply.

#### **VAT: Cash Accounting Schemes**

*On 30 January 2007, the Council authorised Estonia, Slovenia, Sweden and the UK to apply, until 31 December 2009, a special measure derogating from Article 167 of the Sixth VAT Directive.*

The derogation relates to cash accounting schemes for small businesses and the consequential need to override the normal rules on timing of input tax deduction with a rule that deduction by users of these schemes may only occur when the input tax is paid to suppliers.

The UK has had a cash accounting scheme in place since 1987 and a derogation granted at that time has subsequently been extended five times already. The latest application for an extension includes a doubling of the turnover limit for eligibility to use the cash accounting scheme to a figure equivalent to €2,000,000. Estonia, Slovenia and Sweden all propose to introduce new cash accounting schemes with the following eligibility criteria:

- Estonia - all sole proprietors
- Slovenia - turnover limit equivalent to €208,000
- Sweden - turnover limit equivalent to €300,000.

### **Country Updates**

#### **BULGARIA**

##### **Implementation of Sixth VAT Directive**

A new VAT Act and the regulations on its application came into force on 1 January 2007. Overall, the new VAT legislation is close to the Sixth VAT Directive, though certain specific rules have been introduced as well. Up until now, the Bulgarian tax authorities have had a fairly low level of understanding of EU VAT principles. However, this is rapidly changing, and tax training courses are constantly taking place in order to improve the performance of the revenue authorities.

##### *Transitional measures*

Bulgaria has been granted a transitional period for applying the exemption of VAT on international passenger transport services until the requirements of Article 28(4) of the Sixth VAT Directive have been met or the same exemption (derogation) from the Directive’s provisions applies in other EU Member States, whichever occurs earlier.

*Intra-Community trade*

The sections of Bulgaria's new VAT Act that deal with intra-Community trade largely comply with the Sixth VAT Directive, hence, intra-Community supplies of goods will continue to be zero-rated whilst, in the case of intra-Community acquisitions, 20% VAT will be imposed (as was the case under the pre-existing import regime).

The new VAT Act introduces changes to the VAT treatment of the supply of services rendered by non-residents. In general, the so-called "intellectual services" place of supply is determined on the basis of the place where the recipient of the services is established. The recipient in Bulgaria of such services is obliged to self-charge the corresponding VAT (i.e., the so-called reverse charge mechanism applies).

*Changes to the elements of the taxable base*

Indemnities and default payments are excluded from the taxable base. The adjustment of the taxable base upon a sale-at-a-loss transaction is abolished, i.e., the VAT will be calculated on the sale price even if it is lower than the cost, with the exception of transactions involving real estate property.

*Changes in the registration regime*

The threshold for mandatory registration of BGN 50,000 taxable turnover in the last 12 months is retained. Taxable turnover includes zero-rated supplies and supplies of financial and insurance services (when they are related to the main business activity of the entities). Excluded, by contrast, are supplies of tangible and intangible fixed assets and supplies where the recipient is liable for the VAT (i.e., subject to the reverse charge).

At the same time, any business is entitled to register for VAT on a voluntary basis, regardless of the turnover attained.

*Changes in the range of exempt supplies*

Legal services, metal scrap supplies, privatisation deals and supplies of agricultural goods are no longer exempt supplies. The range of VAT import exemptions is narrowed, with the new Act abolishing the exemption of devices for handicapped people and their motor vehicles.

*Changes related to the right to VAT recovery*

The right to recover VAT is retained, provided that a tax document is available and regardless of whether the supplier has accrued for the tax in its accounting books and VAT return

and whether or not the tax document is posted in its VAT sales ledger, which previously were crucial requirements.

The right to recovery of VAT can be exercised if:

- the VAT-registered person possesses an invoice fulfilling the legal requirements of the VAT Act or another tax document appropriate for the particular transaction, depending on the applicable rules;
- the transaction concerned is within the scope of VAT;
- the goods or services received are used for activities subject to VAT;
- for intra-Community acquisitions, a "VAT protocol" has been issued by the recipient of the goods;
- for VAT on importation, there is a customs declaration evidencing the importations.

As a document related to VAT recovery, the "VAT protocol" is one of the main specific national requirements that differentiate the Bulgarian VAT Act and the Sixth VAT Directive. It seems to be a unique document, applicable in Bulgaria only.

*Limitation of the time period for VAT adjustments*

Contrary to the current VAT law, no adjustments can be made to the amount of VAT recovered, if more than five years have passed since the exercise of the right to deduct input VAT in relation to purchases or constructions of fixed assets, as defined by the Corporate Income Tax Act. For real estate, the VAT adjustment period is 20 years.

Furthermore, if, within the VAT adjustment period, goods cease to be used in VAT-able supplies or come into use for both VAT-able and non-VAT-able supplies, there will have to be paid back to the government part of the VAT recovered, corresponding to the remaining years of the adjustment period and to the non-VAT-able activities. The amount to be paid back will be determined on a *pro rata* basis, and not the total amount which was previously the case.

**DENMARK/SWEDEN****VAT: Derogation Concerning Oresund Bridge**

Council Decision 2007/132/EC of 30 January 2007 extends to 31 December 2013 the application of Decision 2000/91/EC authorising Denmark and Sweden to apply a measure derogating from Article 17 of the Sixth VAT Directive in respect of the Oresund Bridge. The derogation under Article 27(1) has been in force since 2000 and relates to the VAT deduction position on the tolls payable for use of the Oresund fixed link between Denmark and Sweden.

As the link is half in the territory of Denmark and half in the territory of Sweden, issues would arise under the normal rules with the practicalities of input tax deduction. Under the derogation, Danish and Swedish taxable persons may deduct the whole of the VAT on their VAT return in their country of establishment and non-established taxable persons may make a claim for the whole of the VAT under the Eighth or Thirteenth Directive. While of local application in itself, the Decision indicates how practical solutions have to be found for these kinds of border payments.

## FRANCE

### Simplified VAT Declaration System

On 17 January 2007, the French tax administration published Guideline 3 F-1-07 dealing with the simplified VAT declaration system. Small undertakings may benefit from a simplified VAT declaration system (*régime du réel simplifié*) if, in the preceding year, their turnover derived from:

- supplies of goods and the provision of accommodation and food and drink for on-the-spot consumption totalling between €76,300 and €763,000; and
- other services totalling between €27,000 and €230,000.

## ITALY

### Finance Bill 2007

On 27 December 2006, the Finance Bill for 2007 was finally approved and converted into Law No. 296. The provisions relating to VAT are summarised below.

- Leasing and transfer of real estate. The Law provides that the lease or transfer of residential properties having particular requisites is no longer exempt from VAT. Furthermore, the leasing of some residential properties will be subject to VAT at the 10% rate if a number of conditions are met.
- Financial and insurance companies. Any activity related to taxes (i.e., collection of taxes due, tax assessments or judgments) supplied by a company within banking and insurance groups or, in general, within groups of companies carrying out mainly VAT-exempt activities, is VAT exempt. Prior to the introduction of this amendment, such activity was subject to VAT at the ordinary 20% rate.
- Reverse charge mechanism. The Law partially amends the provisions contained in the draft of the budget for 2007. The section related to the transfer of real estate has been deleted. Instead, the reverse charge mechanism applies in the case of

services supplied by a sub-contractor to (i) the companies carrying out the construction and refurbishment, and (ii) the main contractor and any sub-contractor; and, subject to EU approval, the transfer of hardware and other equipment.

- Food and drink and hotel accommodation. The Law provides that the VAT on food or drinks and hotel accommodations is now recoverable if supplied during conference meetings and similar events. However, for the fiscal year 2007, VAT on such services is recoverable only for 50% of its amount. Currently, such VAT is not recoverable unless these activities are the core business of the supplier.

## LATVIA

### Application of Reduced VAT Rates

Latvia has decided on the introduction, from 1 January 2007, of a reduced rate on certain labour-intensive services. The new regulations cover the accounting procedure to be adopted for prepayments of these and other services to which the reduced rate now applies.

## PORTUGAL

### VAT: Immovable Property Transactions

Decree-Law 21/2007, published in the Official Gazette on 29 January 2007, amends the VAT Code and provides for a new legal regime for waiving the VAT exemption on the supply and letting of immovable property. The transfer of immovable property in Portugal is subject to a real estate transfer tax known as *Imposto Municipal sobre as Transmissões* (IMT) and is generally exempt from VAT, unless the vendor waives the right to exemption, provided both parties involved in the transaction are Portuguese VAT-taxable persons. The letting of immovable property is also VAT exempt.

By Decree-Law 21/2007, the government has introduced rules to counter tax avoidance schemes involving the supply of immovable property and the supply of certain services connected to immovable property. In particular, the option for VAT taxation in immovable property transactions is only possible provided both vendor/lessor and purchaser/lessee are Portuguese taxable persons and fulfil, for example, the condition that they conduct supplies that give the right to VAT deduction, or in the case of taxable entities that provide both exempt and taxable supplies, those supplies that give right to the deduction exceed 80% of the total turnover (determined on a *pro rata* basis).

Notwithstanding the 80% threshold, the option for VAT taxation remains available for VAT taxable entities whose habitual activity involves construction, reconstruction or acquisition of immovable property for sale or letting. The conditions are expected to have the biggest impact on VAT-exempt businesses, such as those in banking, insurance, health and education.

Furthermore, the transferred immovable property now has to be registered for tax purposes at the tax office and in the case of letting, the annual rent must be equal or higher than one-fifteenth of the acquisition or construction value of the immovable property. The new rules also establish that the option for VAT taxation is only possible upon the first transfer or letting after the construction works of improvement (which result in a change in construction value higher than 50% of the tax registration value) or when the period of 20 years for adjustment is still open. In addition, it will no longer be possible to waive the VAT exemption on the sublease of immovable property.

Decree-Law 21/2007 also establishes an anti-abuse clause for immovable property taxable transactions between related parties, whereby the taxable amount for VAT purposes is determined if certain conditions are met on the basis of the fair market value. In addition, the taxable amount for VAT purposes may also not be less than the taxable amount for the purposes of the annual municipal real estate tax known as *Imposto Municipal sobre Imóveis* (IMI), which is approximately 80% to 90% of the market value.

The Law includes anti-abuse provisions and indicates that certificates for the waiver of the VAT exemption will be issued electronically. Finally, Decree-Law 21/2007 establishes a reverse charge mechanism for the supply of immovable property (if the supplier has opted for VAT taxation) and the supply of construction work, including repair, cleaning, maintenance, alteration and demolition services in relation to immovable property. Under the reverse charge, the person liable to pay tax is the taxable person to whom those supplies are made. The new reverse charge mechanism for construction work will only apply as of 1 April 2007.

## SWEDEN

On the 13 November 2006, two cases were decided in the Swedish Administrative Court of Appeal (*Kammarrätten*, cases 3072-04 and 4907-04) which concerned the right to deduct

input VAT on consultancy services attributable to the sale of shares in a limited partnership or a limited company. In both cases the parent company had prior to the sale supplied taxable services to the company in which it owned shares, i.e., it was actively involved in the management of its subsidiaries. It was an undisputed fact that the selling of shares did not constitute an economic activity of the parent companies.

The court concluded that the supplies made by the parent companies were conducted within an economic activity for which input VAT was deductible. The court also found that the costs were directly linked to the whole business conducted by the parent companies, as an overhead cost, and to the winding up of that business. The court referred to the ECJ's judgments in the cases of *EDM* (C-77/01) and, in particular, *Kretztechnik* (C-465/03).

The tax authority argued that the costs had a direct link to the sale of shares and were therefore not deductible. Both cases have been appealed by the tax authority.

In addition to these two court cases, the Swedish National Tax Board, in a preliminary ruling in January 2007 (case no. Dn 29-06/I, I 2006:6:3), came to the same conclusion regarding the right to deduct input VAT incurred on consultancy services when selling shares. The case concerned a company that was actively involved in the companies in which it owned shares, as opposed to merely holding shares in them. It is expected that the tax authority will appeal to the Supreme Administrative Court in this instance as well.

## UNITED KINGDOM

HM Revenue and Customs (HMRC) have released on their website further information on the partial exemption changes to take effect from 1 April 2007. The changes are the special method "fair and reasonable declaration" requirement and the so-called "combined method" requirement where overseas supplies with a right of VAT recovery are involved. HMRC announced these changes as proposals in the 2006 Budget and were clearly determined from the outset to go through with them, despite conducting a formal consultation exercise. The documents released are the regulatory impact assessment, a guidance document and the draft legislation. ■

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