

EU Tax News

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EU taxation developments
affecting business in Europe

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Editorial

The spring meeting of the European Council of Ministers on 13-14 March 2008 focused on climate change and the second cycle of the Lisbon strategy for growth and jobs (2008-2010). Both issues will have a long-term impact on taxation, especially taxes relating to energy and the environment. Other top-level meetings this year have dealt with strategic energy policy and the stability of financial markets. At the latest meeting of EU Finance Ministers (ECOFIN), issues such as taxation on savings and the fight against tax fraud were again discussed.

In the current Newsletter, we look in detail at the prospects for introduction of the Common Consolidated Corporate Tax Base (CCCTB) and the discussions between the EU and Switzerland on cantonal tax regimes. Other subjects covered include developments in France related to the Parent-Subsidiary Directive and European Commission pressure on Spain over anti-abuse tax rules.

In the Indirect Tax section, we report, for example, on the formal adoption of the new VAT rules on the place of services supply and VAT refunds to taxable persons not established in the EU.

Matthias Roche

Major Developments

Capital Duty Directive

On 12 February 2008, the ECOFIN Council adopted a revised Capital Duty Directive, which simplifies the legislation and ensures that restructuring operations shall not be subject to capital duty.

The recast Directive:

- radically changes the structure of the Directive in order to reflect past amendments, with the ultimate aim of abolishing capital duty but with concessions due to the revenue losses this would imply;
- covers both restructuring operations that involve an increase in capital and restructuring operations that do not. The latter previously fell outside the scope of the Directive;
- gives provisions that apply equally to restructuring operations affected by contributions of assets and by exchange of shares; both types of restructuring operations are henceforth exempt from capital duty,
- ensures that the transfer of a capital company between Member States shall be exempt from capital duty.

Common Consolidated Corporate Tax Base (CCCTB): Wishful Thinking or Future Reality?

Full realisation of the single European market is impeded by the fact that businesses operating across borders have to deal with so many different company tax regimes. To help remove this obstacle, the European Commission wants to introduce a common consolidated corporate tax base, but the political hurdles to CCCTB will be hard to surmount.

Introduction

Ever since its establishment in 1957, the European Community (EC) has sought to create a level playing field for companies operating in Europe, so that European multinationals can compete successfully with their foreign counterparts. The urgent need to complete the single market project has been stressed repeatedly by the European Commission, but the existence of 27 different company taxation regimes continues to distort intra-Community trade and investment. Member States, however, have been reluctant to give up any competency in taxation matters. It is true that the ECJ has already removed a large number of company tax distortions by interpreting the EC Treaty freedoms so broadly. The Court, however, has its limits and cannot abolish all the existing distortions resulting from so many different company taxation regimes existing side by side. The removal of tax obstacles, such as double taxation resulting from transfer pricing or lack of cross-border loss relief, ultimately requires action by Community legislators.

Although it has long been recognised that company tax distortions, in the end, can only be eliminated by removing differences between the corporate tax bases of the Member States, very little has been achieved in this respect over the past 50 years. In 2004, however, the European Commission launched an ambitious project which seeks to introduce within the EC a Common Consolidated Corporate Tax Base. The Commission has announced that it will submit a draft proposal on the CCCTB in September 2008.

Possible Outline and Main Features of CCCTB

While no official proposal has yet been issued, the Commission has published a high-level, non-binding outline of what the future CCCTB might look like.

Based on this outline, it is safe to assume that one of the main features of the CCCTB regime is that it would provide for a common corporate tax base both for single EC-resident companies and groups of EC-resident companies. In addition, EC parent companies with qualifying EC subsidiaries (i.e., with 75% ownership) would be eligible to apply a regime of consolidation. This entails consolidation of the entire tax base of all EC entities belonging to a group. The consolidated tax base would then be attributed to the various Member States where the group companies are resident by means of formulaic apportionment. Each Member State would then be free to apply its own national tax rate on the taxable base attributed to it.

With respect to the calculation of the common tax base, the basic idea would be that this is defined independently. No formal link would thus be made between the tax base and International Accounting Standards (IAS) or International Financial Reporting Standards (IFRS). Basically, the common tax base would include taxable income, such as trading income, passive income and capital gains, less deductible expenses and other deductible items. The CCCTB regime would deal specifically with issues like valuation, depreciation, timing and recognition of income and the deduction of expenses. An exemption would apply for income derived from foreign participations and permanent establishments, such as dividends or capital gains. Interestingly, this would also hold true with respect to such income derived from third countries. In the latter case, however, a switch-over from the exemption to a credit mechanism would apply in cases where this income is taxed at a low rate or subject to a special regime in a third country.

As regards the consolidation, additional rules would be needed to cover, for example, the method of consolidation, the definition of a qualifying subsidiary and changes in the level of ownership. In order to safeguard the budgetary interests of the Member States, specific rules would also be needed, for instance, with respect to losses and hidden profits available upon entering a consolidated group.

Lastly, as regards the apportionment formula, no definitive suggestions from the Commission are yet available. In this respect, inspiration might be derived from Canada and the United States which already have experience with the use of formulaic methods designed to attribute income across borders. Factors such as the shares of property, payroll and gross receipts could be relevant in making such calculations.

Some Outstanding Issues

The introduction of a CCCTB regime would probably be welcomed by the business community operating in the EC. In particular, the possibility of consolidation would do away with major issues of double taxation resulting from transfer pricing and would allow for cross-border loss compensation. Nevertheless, some challenging issues will have to be solved before the CCCTB can become reality.

For example, there is the issue of unanimity. The CCCTB will only become reality if all 27 Member States unanimously agree with the Commission's proposal on a common tax base, including the sharing mechanism. Given the different interests of the various Member States and given the current dynamic political environment within the EC, this seems to be a very challenging task. Should unanimity not be possible, a second-best solution would be to have the CCCTB introduced in a limited group of nine Member States who are in favour of it (under so-called "enhanced cooperation"). A related issue is that it would be impossible to lay down every detailed rule in the final proposal. Delegation of executive powers to the Commission would, therefore, be highly desirable. This should be possible with respect to all issues which do not constitute an essential element of the CCCTB regime. Such an approach would give the Commission more flexibility and allow it to introduce or adopt detailed rules more adequately, without the unanimity of all Member States being required. Member States, on the other hand, may be afraid to give up too many powers and, as a result, be reluctant to confer executive powers on the Commission. This could, however, adversely influence the drafting and acceptability of the final proposal.

Another important issue is whether or not the CCCTB regime should be optional or mandatory for qualifying companies. Naturally, interests will diverge on this issue. Member States may worry about "cherry-picking" practices (i.e., picking only those cases where the tax benefits are high) and may be inclined to make the regime compulsory. The business community, on the other hand, will probably want to have the right to choose whether or not to apply the CCCTB regime. The Commission seems to favour optionality, based however on the principle of "all in" or "all out". It remains to be seen where the balance will be struck.

Lastly, Member States will be faced with challenging technical issues. One may think not only of the introduction and design of adequate thin capitalisation rules, CFC rules and other anti-

abuse provisions, but also of other technical issues such as those relating to the definition of deductible expenses, timing of income and factors relating to the entering and leaving of a consolidated group. Finally, administrative issues will also have to be addressed.

An Uncertain Future for the CCCTB

In 2000 the Commission announced its famous Lisbon Strategy, the aim of which is to make the EC the most dynamic and competitive knowledge-based economy in the world by 2010. Given the current changes in global economic environment, demonstrated by emerging economies in different parts of the world, this objective has lost none of its validity today. Quite the reverse, one may say. So, the question is whether the CCCTB is part of the answer. The European Commission believes it is. Others take an opposite view. For European business, it will also depend on the question of whether the CCCTB is optional or not. One might argue that, "if you can choose you cannot lose", but this may not be entirely true. The CCCTB could also influence national systems of corporate taxation as such. It is, therefore, not easy to predict whether it would, in the long run, be good or bad for a particular Member State.

Even if the CCCTB is seen as desirable, the question is whether its introduction in the future is realistic. Although Member States have been working together since 1957, the introduction of a European common tax base has never seemed to be a serious option. Given the Commission's current efforts in this area, one may ask whether the tide is now turning. The technical problems are complex but should not be insoluble. The submission of a draft proposal by the Commission in September 2008 may prove to be an important landmark. In the end, however, it will be up to the politicians to decide. So, will the CCCTB become reality in the European Community in the future? At present, this is impossible to predict.

In the short term, perhaps the introduction of an optional CCCTB in nine Member States under the enhanced co-operation procedure will be the most realistic way forward. Time will tell.

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Avenues for Resolution of the Swiss-EU Tax Controversy

In the tax discussions between the EU and Switzerland, representatives of both sides made hardly any more headway in the last round of talks, which was held in January 2008. The pressure exerted on Switzerland by the EU's representatives has yielded diverging reactions in the Swiss political arena, which suggests that consensus is still a distant prospect. Analysis of the state of play in this disagreement between Switzerland and the EU over cantonal tax laws indicates that settlement is still not to be expected soon.

Introduction

A decision by the European Commission on 13 February 2007 stated that the EU viewed certain cantonal tax privileges – the mixed company and holding company privileges, for example – as State aid as defined under the 1972 Free Trade Agreement (FTA) between Switzerland and the European Economic Community, and thus as a distortion of competition.

Switzerland has contested this view and, in an effort to resolve the issue, its representatives have since engaged in a series of detailed discussions with Commission officials.

Switzerland's Position

From the very outset, the Swiss representatives have rejected as unfounded the arguments put forward by the Commission. Their reasoning is that:

- holding companies' profits from Swiss and foreign sources are taxed equally, and the holding privilege is equally available to Swiss- and foreign-controlled companies;
- the tax regimes criticised by the EU do not fall within the scope of the FTA, as the latter governs only trade in specific goods, and holding companies are barred from any trading activity;
- as Switzerland does not belong to the EU and is also not part of its single market, neither the competition rules in the EC Treaty, nor the Code of Conduct on Business Taxation agreed between the EU Member States are applicable to Switzerland;
- the tax regimes criticised by the European Commission cannot be viewed as State aid, as they do not favour specific types of production or industry.

On these grounds the Swiss representatives have consistently rejected substantive negotiations with the EU on this matter, although they have indicated their willingness to engage in an open dialogue on tax matters.

The opposing viewpoints were discussed in greater detail when representatives of Switzerland and the Commission met on 12 November 2007 and 23 January 2008. At the end of January, the EU delegation adopted a different approach by presenting features of certain tax systems that remain both competitive and compatible with EU rules, such as those applied in Ireland, Luxembourg and the Netherlands.

The Roots of the Disagreement

The debate and discussion between the EU and Switzerland was primarily triggered on grounds of economic and fiscal policy orientations of the EU that differ from those of Switzerland. At the request of the Swiss Council of States' Committee for Economic Affairs and Taxation (motion 07.3003), the Federal Council, on 7 November 2007, presented a report under the title *State aid to companies: company taxation and tax competition – developments in the European Union*. The report's conclusion is that Swiss lawmakers take a positive view of tax competition, while the opposite approach appears to prevail within the EU, where tax competition has been restricted at the same time as extensive public aid has been built up.

In the 1990s, the representatives of the EU Member States – under financial and political pressure to join the single European currency (the Euro) – agreed to an initiative put forward by the European Commission to combat "harmful tax competition". The autumn of 1997 saw the adoption of a Code of Conduct on Business Taxation that considerably restricted tax competition within the European Union.

The EU Member States undertook to repeal those tax measures that were regarded as "harmful" and to refrain from introducing such measures in the future. They also agreed to promote compliance with the Code of Conduct in third countries.

Entrenchment or Breakthrough?

One of the things this involves is the examination of tax benefits accorded to individual enterprises with a view to ascertaining whether they, when compared with the level of taxation usually applicable in that Member State, tend to

produce a markedly lower effective tax burden, or whether such benefits apply only to transactions with non-residents. On the margin of the talks on 12 November 2007, the EU ambassador Michael Reiterer spelled out the EU representatives' view that the differential treatment of foreign-source income versus Swiss-source income under the scrutinised tax regimes constituted a problem. It should be noted in this context that income from foreign sources is taxed in Switzerland at lower rates than that from domestic sources. This differential taxation should, in Ambassador Reiterer's view, be eliminated.

Looked at from this angle, the Commission's argument to the effect that such tax regimes violate the Free Trade Agreement appears to be no more than a means to an end. After talks with representatives of the European Commission on 6 December 2007 regarding topics in the current round of bilateral negotiations (on trade in agricultural products and access to the single electricity market), Secretary of State Michael Ambühl admitted that it was "not to be excluded" that the EU would tie further progress in negotiations on such matters to the resolution of the tax dispute.

It is to be expected that the Commission representatives would prefer to wait for the third round of negotiations, which is scheduled for early April, to decide shortly afterwards as to whether sufficient progress has been made. If this were not the case, other ways may be found of increasing pressure on Switzerland. As long as no amicable agreement is reached between Switzerland and the EU, some uncertainty over the future of the proposed tax regimes will remain.

Contrasting Positions

In the political and economic debate in Switzerland, two opposing positions are being taken up. One camp, taking national fiscal sovereignty as its starting point, argues that further challenges to the Swiss tax system should be resisted and that criticism from the EU should be ignored.

Advocates of this position expect that the European Commission may settle in for a long, drawn-out debate, because, with its first strike, it has already attempted to create insecurity amongst potential investors. It is to be expected that these uncertainties could be used to make Switzerland seem a less attractive prospect by comparison with EU Member States.

The other Swiss camp is fostering an independent tax reform. Such a reform would not be negotiated with the EU, but it would make Swiss tax regimes even more appealing while taking into account the concerns expressed by the EU. On 23 February 2008, the Federal Department of Finance announced the creation of a working group for the elaboration of further proposals for tax reform.

One may in this respect wonder whether certain elements of the Swiss tax system – some of which do, after all, date back more than 50 years – are still appropriate in a fast changing and globalising world. It also needs to be borne in mind that foreign states are from time to time creating new incentives to attract businesses, while at the same time enacting legislation against the use of certain foreign tax regimes.

The Swiss-EU debate raises the question as to just how competitive the Swiss tax system still is. If it turns out that it has lost ground, adjustments may be envisaged to maintain its flexibility and competitiveness while addressing the European Commission's concerns. Various possible solutions have been discussed over recent months.

Reducing or Giving up Corporate Income Tax?

One possibility is that the federal direct tax rate for legal entities – currently 8.5% – could be substantially reduced. The legislators in a number of Swiss cantons have already reduced income tax rates applicable to legal entities. Combined with the envisaged reduction of federal direct tax, this could certainly result in attractively low tax burdens for all companies in Switzerland.

A quite different approach involves consideration of the possibility of completely doing away with corporate income tax and making up the shortfall by means of indirect taxes on resources. It remains to be seen to what extent Swiss legislators will use the dialogue with the EU on specific tax regimes as an opportunity to come up with a system of taxation that appeals to all companies.

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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

Thin Cap Rule Contravenes Freedom of Establishment

In its judgment of 17 January 2008, the ECJ issued a decision in the *N.V. Lammers & Van Cleeff* case (C-105/07). This case concerns the Belgian thin capitalisation rule, according to which interest payments are qualified as dividends when either the interest exceeds the market rate or the loan exceeds the sum of the taxed reserves at the beginning of the year and the paid-up capital at the end of the year.

Because the application of the provision is dependent on the residency of the director (company) holding the claim (i.e., is only applicable to foreign directors), the ECJ decided that the Belgian rules constitute a restriction on the freedom of establishment, since they could inhibit companies established in another Member State from managing companies in Belgium or even from acquiring, creating or maintaining a subsidiary in Belgium.

The ECJ stated that although this regulation could be justified for reasons of preventing abusive practices, it goes beyond what is necessary to attain that objective, because the limit laid down also affects situations in which the transaction concerned cannot be regarded as a purely artificial arrangement. Therefore, the ECJ concluded that the present Belgian thin capitalisation rule breaches the freedom of establishment.

Belgian Turnover Tax on Pharmaceutical Companies

The European Commission has decided not to raise any objections, under EU State aid rules, to a series of tax incentives introduced by Belgium as part of the reform of the tax paid by pharmaceutical companies on sales of reimbursed medicines (“turnover tax”). The computation of the turnover tax is based on the sales of reimbursed medicines. The law of 10 June 2006 exempts certain reimbursed medicines from the computation base of the turnover tax and grants reductions of the tax. The Commission concluded that the measures were not against EU interests and are compatible with the common market in accordance with the exceptions provided

for in Article 87(3)(c) of the EC Treaty which authorises aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest.

Commission Presses Belgium to Implement Merger Directive

The European Commission has formally requested Belgium to transpose into national law the 2005 Directive (2005/19/EC) amending the Merger Directive. 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 the relevant national legislation is not amended in order to comply with the reasoned opinion, the Commission may decide to refer the matter to the ECJ. The deadline for transposing the second part of the provisions of Directive 2005/19/EC expired on 1 January 2007. Article 2 paragraphs (2) and (3) of the Directive stipulates the obligation of Member States to communicate in due time to the Commission the measures adopted at national level in order to implement the provisions of the Directive.

The European Commission has already referred Belgium to the ECJ for failing to transpose into national law the provisions of the same Directive which were due to be transposed by 1 January 2006 (i.e., the provisions regarding the transfer of the registered office of a European Company (SE) or a European Co-operative Society (SCE) and the inclusion of the SE and the SCE in the list of companies covered by the Directive). The ECJ case reference number is C-392/07.

DENMARK

Jäger Case Affects Danish Rules on Inheritance Tax

The ECJ ruled on 17 January 2008, in the case of *Theodor Jäger v Finanzamt Kusel-Landstuhl* (C-256/06), that the German rules regarding calculation of inheritance tax and, in particular, the rules regarding valuation of assets in the form of agricultural land and forest in Germany and France constitute a restriction on the free movement of capital. The ruling will have a direct impact on Danish inheritance tax rules.

More importantly, it affects the taxation of foreign real estate owned by Danish individuals for residential purposes. It is expected that the Danish tax authorities will issue new guidelines in due course.

FRANCE**Article 4(2) of the Parent-Subsidiary Directive**

Pursuant to Article 216 of the French Tax Code, a company receiving dividends which benefit from the parent-subsidiary exemption must include in its corporate income tax base the lower of (i) 5% of the tax-exempt dividends received, including the attached tax credits, or (ii) the amount of all the expenses incurred by the parent company for the fiscal year during which it received the dividends.

The French Supreme Tax Court considered that taking into account the tax credits attached to the tax-exempt dividends when calculating the 5% non-deductible portion might affect the tax neutrality of cross-border distributions of dividends when the tax credits may not be offset. The Court, therefore, referred to the ECJ (C-27/07) the question as to whether or not such calculation is authorised under Article 7(2) of the Parent-Subsidiary Directive, which provides that the application of domestic or agreement-based provisions designed to eliminate or lessen economic double taxation of dividends, in particular provisions relating to the payment of tax credits to the recipients of dividends, shall not be affected by the Directive.

Disagreeing with the analysis of the French court, the ECJ Advocate General (AG) Eleanor Sharpston concluded on 24 January 2008 that such calculation is not contrary to Article 4(2) since dividends effectively received, and related tax credits compensating foreign withholding taxes should be considered as “profits distributed by the subsidiary”. According to the AG, this literal interpretation of Article 4(2) is supported by (i) Article 5 of the Directive which authorises some States to levy a withholding tax on distributed profits and (ii) the fact that applying the French regulations only leads to calculating the non-deductible portion on the total amount of the dividends declared by the distributing company.

Interest on Illegal State Aid

On 12 February 2008, the ECJ rendered its decision in the *CELF* case (C-199/06), which relates to a subsidy granted by France since 1980 to an exporter of books in French to offset the extra costs of handling small orders by foreign buyers.

The ECJ ruled that:

- in a case when a form of State aid which has not been notified prior to its implementation has been recognised as compatible with EC law, EC law does not require the

reimbursement of the whole aid but only the payment of interest calculated on the amount of the aid received during the period of illegality;

- the period between the Commission’s decision on compatibility and the cancellation of this decision by the ECJ must be taken into account when calculating the interest, except where the beneficiary can cite exceptional circumstances.

If the ECJ, opposing the AG’s opinion, has softened its own case law with regard to the first part of its decision, it maintains a hard line on the second part which leads, in the case at hand, to the calculation of the interest to be paid on the total amount of the subsidies received since 1980!

The ECJ, which expressly mentioned “a procedural situation such as that in the main proceedings”, may have considered that, in this case, the multiplication of the actions for annulment against the Commission decisions precluded the recognition of a legitimate expectation. On the other hand, this decision illustrates that the free competition principle still prevails, in ECJ case law on State aid, over the legitimate expectation principle, except in “exceptional circumstances” which are not recognised in a case where the aid has been declared compatible with EC law on several occasions.

As a consequence, beneficiaries of forms of State aid which have not been formally notified by the States, including aid relating to derogated State aid regulations, should consider notifying the Commission about the aid in order to secure their position.

GERMANY**Deductibility of Losses of EU Permanent Establishment**

On 13 February 2008, AG Sharpston delivered her opinion in the *Lidl Belgium* (C-414/06) case, stating that it is contrary to the freedom of establishment (Article 43 EC) if Germany precludes the deductibility of losses incurred in the taxpayer’s permanent establishment (PE), even if the respective double tax treaty (DTT) provides for the exemption method with regard to profit from PEs.

Lidl Belgium, a company resident in Germany, carried out business activities, inter alia, via a Luxembourg PE. The deduction of the losses incurred by the Luxembourg PE at the level of Lidl Belgium was denied by the German tax authorities.

Until 1998 German tax law allowed for a deduction of the losses, combined with a recapture rule, but as of 1999, such loss relief was no longer granted. Contrary to decisions made by other European tax courts, the referring court, the *Bundesfinanzhof* (Federal Tax Court), indicated that the exemption method provided in the DTT applies not only to profits but also to losses of PEs.

Noting that the measure at hand constitutes a restriction of the freedom of establishment and not of the free movement of capital, the AG focused her analysis on the possibility of a justification. In this context, she referred to the principles established in the *Marks & Spencer* case (C-446/03) which concerned the deduction of losses incurred by foreign subsidiaries. While the AG confirmed the application of the first two justifications, namely the preservation of the allocation of the power to impose taxes between the Member States and the prevention of the double use of losses, she denied the applicability of the third justification, i.e., the risk of tax avoidance by routing losses to high tax countries (“loss trafficking”).

Although, in her opinion, not all three justifications have to be applicable cumulatively, referring to the principle of proportionality, she concluded that the measure did go beyond what is necessary to secure the attainment of its objectives. This, she continued, was also clear from the German legislation prior to 1999, which expressly provided that a company could deduct the losses incurred by a foreign PE, subject to a recapture rule whereby the deduction was brought back into account in subsequent years as far as the PE made profits.

The argument of some Member States that significant practical difficulties precluded an adoption of a system allowing for deduction of losses, combined with a recapture of loss relief, was rejected by referring to the former German legislation, the practice of some other Member States as described in the European Commission’s communication of 19 December 2006, and the Mutual Assistance Directive (77/799/EEC).

If the ECJ follows the AG’s opinion, companies may claim for the deduction of losses incurred by PEs established within the European Union (EU) or the European Economic Area (EEA). Such a reduction cannot be claimed with regard to third country PEs. Note the contrast with the ECJ decision of 6 November 2007 in the *SEW* case (C-415/06).

Non-deductibility of Currency Losses of Foreign PEs

On 28 February 2008, the ECJ issued its judgment in the case of *Deutsche Shell* (C-293/06), stating that the non-deductibility of currency losses suffered by a German company upon repatriation of start-up capital granted to its EU permanent establishment is contrary to the freedom of establishment (Articles 43 and 48 EC).

In 1974, Deutsche Shell, a German corporation, set up a PE in Italy. Deutsche Shell provided its PE with start-up capital, which was entered in the separate German commercial and tax account at the Deutsche Mark (DEM) exchange rate obtaining at the time of each payment made in Italian Lire (ITL). In 1992 Deutsche Shell closed down the PE. The generated capital gain and other connected profits were taxed in Italy. As this was done in ITL, the currency loss (from trading DEM into ITL) was not recognised and was not taken into account for the purposes of Italian taxation.

Deutsche Shell argued that the currency loss should be taken into account and set off against its profits when calculating its liability to tax in Germany. However, the German tax authorities applied the DTT between Italy and Germany. Given the terms of that DTT and its general application in German law, it was considered that there was no scope for the disputed currency loss to be brought into the computation of Deutsche Shell’s tax liability in Germany. This was because that loss arose, albeit indirectly, “through the activity of” the branch in Italy and was therefore regarded as part of its income. It could, therefore, be taken into account for tax purposes only in Italy.

The ECJ pointed out that if the currency loss constituted a real economic loss, which is for the national court to decide, the disregarding of such loss would impede or at least render less attractive the setting-up of a PE in another Member State with a different currency. Considering that none of the national tax authorities took the currency loss into account, there was an obstacle to the freedom of establishment. Regarding a possible justification for such an obstacle, the ECJ rejected both overriding reasons of public interest brought up by the German tax authorities, i.e., the coherence of the German tax system and the balanced allocation of the power to impose taxes between the different Member States. With regard to the coherence argument, the ECJ stated that the currency loss of Deutsche Shell was not offset by any tax advantage – neither in Germany nor in Italy. As far as the allocation of the power to tax by DTTs is concerned, the ECJ held that “it is unacceptable for a Member

State to exclude from the basis of assessment of the permanent establishment currency losses which, by their nature, can never be suffered by the permanent establishment”.

The ECJ, therefore, concluded that it is contrary to the freedom of establishment (i) to exclude currency losses regarding the repatriation of start-up capital of a PE from the national basis of assessment; and (ii) to allow the deduction of currency losses as operating expenditure only insofar as the PE does not make any tax-free profits. As far as currency losses occur with regard to EU/EEA PEs, such losses must be taken into account by the Member State of the owner company, irrespective of whether or not a DTT provides for the exemption method.

IRELAND

2008 Finance Bill: Foreign Dividends

Ireland's 2008 Finance Bill contains some measures that are of interest from an EU perspective. The most significant development is the introduction of a package of measures to address the ECJ decision in the *Franked Investment Income Group Litigation* case (C-446/04).

The case concerned the UK treatment of distributions received by UK companies from companies resident in other EU Member States. The ECJ concluded that Community law did not prohibit a system whereby a Member State does not impose a charge to tax on domestic dividends, while also subjecting foreign source dividends to taxation with a credit. This is on the proviso that the foreign source dividends are not subject to a higher rate of tax than the rate that applies to domestically sourced dividends. At the time of writing, the UK High Court had not yet given its opinion on the ECJ decision.

Under the Irish tax code, distributions received from non-Irish resident companies are fully liable to corporation tax at rates up to 25%, subject to any tax credit for underlying taxes suffered by the non-resident companies (where available). While the Irish tax system is similar to the UK tax code in many respects, a fundamental difference is that this 25% rate is double the 12.5% rate that generally applies to the trading profits of Irish companies. There was a concern that the application of the 25% rate would not be compatible with the ECJ decision.

The 2008 Finance Bill provides that, with effect for dividends received on or after 1 January 2007, the 12.5% corporation tax

rate is to apply to certain dividends received from companies resident in an EU Member State or in a country with which Ireland has entered into a double taxation agreement. However, unless a 75% safe harbour provision applies, the dividend must be wholly sourced from trading profits. Otherwise, apportionment may be necessary.

The change aligns the taxation of the dividend with the rate of tax that would generally apply if the profits of the subsidiary had arisen in Ireland. In effect, the Irish tax authorities are now in a position to argue that the domestic exemption, if it is regarded as the equivalent of taxation at 12.5% with a credit for tax at 12.5%, is comparable with the taxation of a foreign dividend at 12.5% with a credit for foreign tax. The “trading profit” requirement does not apply to portfolio dividends, i.e., where the dividend is received from companies in which the Irish company has less than a 5% interest. The Irish tax authorities have not yet indicated how they will handle existing claims made in respect of pre-1 January 2007 dividends.

ITALY

Discriminatory Taxation of Outbound Dividends

The European Commission has been at odds with Italy over the taxation of outbound dividends and on 30 November 2007 referred the matter to the ECJ (C-540/07). According to the Italian legislation in force until 31 December 2007, dividends paid out to foreign companies, except those within the scope of Directive 90/435/EEC (the Parent-Subsidiary Directive), were subject to a withholding tax equal to 27% of their amount (reduced to a lower percentage on application of a DTT concluded by Italy and the State of residence of the beneficiary). However, domestic dividends were taxed on only 5% of their gross amount at the ordinary tax rate of 33%. The levy on these dividends was, therefore, equal to 1.65% of their gross amount.

The European Commission issued a “reasoned opinion” that was sent to Italy on 28 June 2006, which led Italy to modify the internal provision on taxation of dividends only with effect from 1 January 2008, leaving the discriminatory treatment in place for dividends on profits accrued until 31 December 2007.

According to the European Commission, the internal withholding tax of 27% was contrary to the principle of the free movement of capital, since it had a negative effect on the profits

and investment decisions of non-resident shareholders in Italian companies, making it, at the same time, more difficult for the same Italian companies to raise capital abroad.

Therefore, the European Commission asked the ECJ to assess and declare, in the case at hand, the clear infringement of Article 56 EC, which prohibits any restriction on the free movement of capital between the Member States, and of Article 40 of the EEA Agreement, which governs in a similar manner free movement between the states party to that agreement.

According to the European Commission, the Italian internal withholding tax of 27% may also conflict with the right of establishment as laid down by Article 31 of the EEA Agreement, since it is also applicable to controlling shareholdings in Italian companies owned by companies established in the states party to that agreement (in which case the Parent-Subsidiary Directive does not apply).

Note that the amendments enacted by means of the Budget law for 2008 changed the internal withholding tax, granting to non-resident corporate shareholders the same treatment provided to Italian corporate shareholders. Thus, for companies resident in EU Member States, an internal withholding tax of 1.375%, (i.e., 5% of 27.5% – the new corporate tax rate) applies to dividends on profits accrued after 31 December 2007.

LITHUANIA

Collective Investment Undertakings (CIUs)

On 1 March 2008, amendments to the Lithuanian law on collective investment undertakings came into force. As a consequence, new types of corporate investment vehicle, eligible for favourable tax treatment under the Law on Profit Tax, are introduced. These corporate investment vehicles include real estate investment undertakings (REITs), private equity investment undertakings and alternative investment undertakings.

According to the provisions of the Law on Profit Tax, investment income of these undertakings such as rental income, capital gains upon disposal of property and shares, as well as interest income is expected to be treated as non-taxable income, except for dividend income or any other income from distributed profits. Dividends received by the CIUs are subject to 15% profit tax. The rate may be reduced to 0% in the case of qualified participation.

NETHERLANDS

Dutch Wage Tax on Non-resident Artists and Sportsmen

Under the Dutch Wage Tax Act, Dutch wage tax is levied upon, inter alia, a group of mainly non-resident artists and sportsmen who, under an agreement of short duration, perform services in the Netherlands. The Dutch wage tax should, in general, be withheld by the person who agreed the performance of service with the foreign organisation (the “withholding agent”) at a rate of 20%. The withholding should take place even if the fee is not paid by the foreign organisation to the individual artists and sportsmen.

On 27 December 2007, the Lower Dutch Court of The Hague decided that, under certain circumstances, the provisions in the Dutch Wage Tax Act for groups of artists and sportsmen are an unjustified restriction of Article 49 EC (freedom to provide services). In the case at hand, a professional UK soccer team played a friendly match in the Netherlands against a professional Dutch soccer team. In this context, the Dutch soccer organisation paid a fee to the UK soccer organisation as agreed between the two bodies. The Dutch soccer organisation, however, did not withhold Dutch wage tax, although the Dutch organisation was a withholding agent according to the Dutch Wage Tax Act. The UK soccer organisation did not pay the fee to the soccer players as they were in salaried employment.

The Lower Dutch Court of The Hague considered that the withholding requirement for Dutch organisations (as recipient of a service) can restrain Dutch organisations from agreeing services with foreign organisations. If a soccer team was hired which consisted of mainly Dutch players, the recipient of the service would not be regarded as withholding agent. Moreover, the withholding requirement has a mixed character, as it affects both the profit of the organisation (insofar as the fee is not paid to the individuals) and the fee that is paid to the individuals (as salary).

Taking into account that foreign organisations will incur more costs and have a heavier administrative burden than Dutch organisations, since foreign organisations will claim a tax credit for the Dutch taxes paid in the country of residence, the foreign organisations may ask a higher fee for the service which may also lead Dutch organisations to refrain from agreeing services with foreign organisations. Additionally, the Dutch organisations have an extra administrative burden when

receiving such foreign services. The Lower Dutch Court of The Hague decided that, in the present case, the provision at issue was a restriction of the freedom to provide services. The objectives of the withholding requirement – to simplify the levy and recovery of taxes – could not justify the restriction as this is not a proper measure, also taking into account that the necessary information to levy the taxes could be retrieved by means of the Mutual Assistance Directive.

Note that on 31 October 2007 the Lower Dutch Court of Haarlem ruled that the provisions of the Dutch Wage Tax Act regarding the groups of non-resident artists and sportsmen were not in violation of the principle of equality and the EU fundamental freedoms, irrespective of whether the fee was paid by the foreign organisation to the individual sportsmen.

PORTUGAL

Discriminatory 2005 Tax Amnesty Legislation

Further to the reasoned opinion sent to Portugal on 16 May 2007, the European Commission has now decided to refer Portugal to the ECJ because of its 2005 tax amnesty legislation, which allowed for the disclosure and regularisation of undeclared funds held abroad by filing a confidential statement before 16 December 2005. Under the amnesty law, resident individuals were required to pay a penalty equal to 5% of the value of the relevant investments. However, under the same law, the penalty was only 2.5% if the funds disclosed were invested in Portuguese government bonds. Thus, persons making use of the amnesty were dissuaded from keeping their newly disclosed assets in investments other than Portuguese government bonds.

The European Commission considers that such regularisation at a preferential penalty rate of 2.5% for investments in Portuguese government bonds (instead of 5% in any other assets) is an infringement to the free movement of capital, guaranteed by Article 56 of the EC Treaty.

SPAIN

Commission Approves Tax Credits for Innovation

The European Commission has authorised, under State aid rules, a Spanish corporate tax credit for revenues from patents, designs, models, plans, secret formulas and processes. In August 2007, Spain notified the Commission of its proposal to grant this

corporate tax credit. The Commission has assessed the measure and concluded that it is a general measure rather than targeted at a particular type of company or region and therefore does not constitute State aid.

Under this new tax measure, only 50% of the revenue obtained from licensing the intangibles will be taxed in Spain, provided, among others, that (i) the Spanish company has developed the intangibles; (ii) the intangibles requirements are used in a business activity, and (iii) the licensee is not resident in a tax haven.

The Commission found that the tax credit would be open to all companies, irrespective of their size or sector, that there would be no restriction concerning the location of the eligible activities, and that the public administration had no discretion in applying the measure, as the criteria are objective and defined *ex ante* in the implementing regulation. Moreover, the overall budget to be spent by the State for the measure is not limited and the scheme constitutes a reduction of the tax base rather than a reduction of the tax rate. Therefore, the Commission has confirmed that the tax credit is fully compliant with the EU requirements on State aid and may now be applied by qualifying Spanish taxpayers.

Anti-abuse Clause of the Parent-Subsidiary Directive

The Spanish law implementing the Parent-Subsidiary Directive includes an anti-abuse provision which denies the dividend withholding tax exemption to EU parent companies having more than the 50% of non-EU resident ultimate shareholders, unless the parent company develops an activity related to the Spanish subsidiary activity or proves that it has been incorporated for a valid business reason other than saving tax.

On the basis of this provision, a resolution of the Spanish Central Administrative Court, dated 14 June 2007, has denied the application of the Parent-Subsidiary Directive to a Dutch company, which was fully owned by an Austrian company listed on the stock exchanges of Vienna and Frankfurt. According to the court, the taxpayer could not prove where the ultimate shareholders were resident, or the valid business reason for having set up the Dutch company.

Under this scenario, we believe that the Spanish tax authorities could deny these provisions to non-European resident groups, unless the parent company is directly related to the activity of the Spanish company. This interpretation of the Parent-Subsidiary Directive anti-abuse clause could well bring

objections from the European Commission, as it has occurred with certain other Spanish anti-abuse provisions.

Commission Pressures Spain over Anti-abuse Tax Rules

The European Commission has sent to Spain a formal request to amend three discriminatory anti-abuse tax rules, according to which income originating from Cyprus and other EU territories considered as tax havens for Spanish tax purposes is taxed more heavily than domestic income.

The Commission considers these rules incompatible with the freedoms of the EC Treaty because they may deter Spanish shareholders from investing in companies established in those territories and may impede companies located in those territories from raising capital in Spain. This request is in the form of a reasoned opinion, the second stage of the infringement procedure under Article 226 of the Treaty. If Spain does not amend its law within two months, the Commission may refer the case to the ECJ.

The first anti-abuse provision attacked by the Commission is the non-application of the Spanish participation exemption to dividends received from companies located in these territories, in which a Spanish company holds a participation of more than 5%. The Commission notes that an exemption would be granted if dividends were distributed from companies located in Spain or in other Member States.

The second provision is the fact that the Spanish rules on Controlled Foreign Companies (CFCs) still apply to these territories. The Commission considers that the Spanish legislation is contrary to Community law as interpreted by the ECJ, because it goes beyond what is necessary to prevent only wholly artificial arrangements and may also apply to subsidiaries carrying out genuine economic activities in Cyprus and those other territories.

Finally, the Commission objects to the fact that Spanish legislation does not allow Spanish companies to consider as tax deductible the provision for depreciation of holdings in companies located in Cyprus and those other territories, thereby creating a higher tax burden for Spanish shareholders investing in those territories than for Spanish shareholders investing nationally or in other Member States. ■

Indirect Tax

Latest EU Developments

VAT Package: New Rules on Place of Supply of Services

On 12 February 2008, the European Council adopted the legal texts for the VAT package agreed on 4 December 2007. Under the new rules, VAT on services will accrue to the country where the services were provided and a new, quicker procedure will be established to claim VAT refunds.

The aim of the new legislation is to harmonise any disparities in the field of services supply, especially in cases where the services can be supplied from a distance and service suppliers are located in countries with lower VAT rates, leading to revenue reductions for some Member States. The new procedure will allow service providers to claim VAT electronically from Member States where they have not registered but have paid VAT. Businesses will be paid interest if Member States are late making refunds. The new rules are applicable from 1 January 2010. (Further details were given in *EU Tax News*, Issue 23 January/February 2008.)

Excise Movement Control System (EMCS)

On 14 February 2008, the European Commission published a proposal (COM/2008/78) on a legal framework for the use of the Excise Movement Control System. The proposal, which should be applicable as of April 2009, seeks to revise the Directive (92/12/EEC) on the general arrangements for products subject to excise duty (alcoholic beverages, tobacco products and mineral oils) and will help to strengthen the fight against fraud and simplify certain rules for private and commercial cross-border purchases. In addition, it aims to liberalise existing rules for alcoholic beverages bought in one Member State and transported to another, and to simplify rules on the commercial movement of excise goods. More precisely, the EMCS:

- would provide a legal framework for the use of a computerised system to monitor the movement of excise goods for which no tax has yet been paid;
- would allow both Member States and traders to monitor movements electronically in real time;
- would reduce the time needed for the discharge of tax liability for excise movements;
- would provide excise authorities with the essential tools to effectively address fraud by permitting a more integrated, faster and risk-oriented approach to controls.

Travel Agents' Scheme

The European Commission has issued a request in the form of a "reasoned opinion" to the Czech Republic, Finland, France, Greece, Italy, the Netherlands, Poland, and Portugal to amend their legislation on the application of the special VAT "margin" scheme for travel agents. The special margin scheme is aimed at simplifying the application of VAT for travel agents where they sell travel packages, including services, to individual travellers.

However, the margin scheme does not apply to travel agents who sell holiday packages to other travel agents who then resell them. Competition in the tourism industry has been distorted by uneven application of the current rules and the non-application of VAT to non-EU operators selling holiday packages to EU residents. To address this problem, the Commission wants to extend the current special margin scheme to cover sales to travel agents as well as to individuals – a proposal it first launched in 2002.

Background

Without the margin scheme, a travel agent who, for example, purchases restaurant services and car rental services from third parties in other Member States and puts them together in a travel package that he sells in his own name, would be subject to VAT on the services supplied in his own Member State. He would be entitled to a refund of VAT charged abroad on the restaurant services etc. but would have the inconvenience of having to reclaim it from a Member State other than his own. Moreover, the price of the travel package would be very much influenced by the level of tax applied in his Member State, despite the fact that the travel may take place in another Member State. Under the margin scheme, all the elements of a single travel package are definitively taxed in the Member State where the travel takes place. The relevant tax is paid by the tour operator who, though unable to obtain input deduction or a refund, is only subject to VAT, for the overall package he sells, in the Member State where he is established.

Car Registration Tax

The European Commission has sent "reasoned opinions" to Austria, Malta and Finland, asking them to adapt their legislation on the inclusion of car registration tax within the amount on which VAT is levied when road vehicles are supplied. The Commission considers that registration tax should not be included in the taxable amount for VAT.

Background

In the sale of road vehicles, Austria, Malta and Finland include the amount of their car taxes (the Austrian *Normverbrauchsabgabe*, the Maltese *taxxa ta' registrazzjoni ta' vetturi bill-mutur* and the Finnish *autovero*) within the amount on which VAT is levied. In the *De Danske Bilimporterer* case (C-98/05), the ECJ has examined whether the taxable amount for VAT purposes, in the case of supplies of means of transport, must include the amount of the registration tax (RT). This tax is usually paid by the supplier to the tax authorities and afterwards repaid to him by the purchaser along with the price of the vehicle. The RT in this case was levied in Denmark.

The ECJ ruled that, in the context of a contract of sale which provides that the dealer will supply a vehicle registered for a price which includes the registration tax he paid before supplying the vehicle, the amount of that duty must not be included within the taxable amount of the VAT charged on the sale of the vehicle. This is because, firstly, the RT is charged by reason of the registration of the vehicle and not by reason of the supply and, secondly, because the RT is paid by the supplier of the vehicle on behalf of the purchaser.

The European Commission concluded that the car taxes levied in Austria, Malta and Finland are basically the same as the Danish tax examined by the Court. Thus, all are one-off taxes which are payable on the acquisition of the motor vehicle or as a condition for bringing it into use on the territory of the Member State concerned. Moreover, the Commission has already initiated infringement procedures against Poland and Portugal concerning the same matter. The Commission takes the view that the criteria of the ECJ in the Danish case (C-98/05) must be applied to the car taxes levied in Austria, Malta and Finland. These Member States have been given two months to bring their legislation into conformity with Community law.

Refund of VAT to Non-established Taxable Persons

The European Commission has sent a reasoned opinion to the UK and referred it to the ECJ, following the UK's refusal to amend its legislation concerning the refund of VAT borne by taxable persons not established in the EU. It has also requested Spain to change its administrative practice concerning the refund of VAT to taxable persons established in a Member State of the Community other than Spain.

Country Updates

FINLAND

Public Legal Aid Services and VAT

The European Commission has decided to refer Finland to the ECJ regarding its legislation excluding from the scope of VAT the services supplied by public legal aid offices. According to current practice in Finland, legal aid provided by an attorney working for a public office is not subject to VAT, whereas similar legal services from a private attorney fall within the scope of the tax and are charged VAT.

The Sixth VAT Directive requires that the services provided by public authorities be subject to tax if the exemption from tax would significantly distort competition. In Finland, depending on the applicant's financial situation, public legal aid may be given free of charge or in exchange for a partial contribution to the costs. In matters that require a court hearing, the recipient of legal aid may choose to be assisted by either a private attorney or a public legal aid office attorney.

The Sixth VAT Directive calls for inclusion in the tax regime of services provided by public authorities, where doing otherwise would give rise to significant distortions of competition. The European Commission, having heard the Finnish authorities' observations on this issue, concluded that the different VAT treatment granted to essentially identical services caused distortions to the detriment of private attorneys. It therefore issued a reasoned opinion in December 2006. Since the reply it received from the Finnish authorities in February 2007 was unsatisfactory, the Commission decided to refer the case to the ECJ.

FRANCE

Undertakers' Operations

The European Commission has decided to refer France to the ECJ for applying different rates of VAT to operations performed by undertakers as part of the same service, following a reasoned opinion sent to France in July 2007. Services provided by undertakers in France do not attract a single rate of VAT, the reduced rate applying to the transportation of a body by vehicle whereas the movement of a body by bearers and other operations generally provided by undertakers attract the normal rate. The Commission considers that France is thereby

applying an artificial distinction at variance with Community case law as regards the concept of a single composite service. The case law treats services provided by undertakers for a particular funeral and the goods delivered in connection with the latter as forming one and the same service.

The Commission therefore concluded that a single rate of VAT must apply to such operations and stressed that France can choose to apply the reduced rate to the "supply of services by undertakers and cremation services, and the supply of goods related thereto" in accordance with point 16 of Annex III to the Sixth VAT Directive, but the same choice must apply to the whole service. If France opts not to make use of that possibility, it must by the same logic apply the normal rate of VAT to the service as a whole.

GERMANY

Fraudulent VAT Refunds in the *Netto* Case

Between 1992 and 1998, Netto, a German supermarket chain, refunded VAT to customers on presentation of the till receipt, customs forms and a non-EU passport on the grounds that the goods were exported to Poland (which was a non-EU member at that time) for personal use. In 1998 the regional tax authority (*Finanzamt*) found that a substantial proportion of the documents submitted to Netto were counterfeit and therefore refunds should not have been made. The ECJ ruled on 21 February 2008 that Netto does not have to repay the VAT mistakenly refunded to customers as Netto could not "even by exercising due commercial care" have known that there was false pretence.

GREECE

Refund of Unduly Paid Taxes

Following the judgment of the ECJ in the *BP Soupergaz* case (C-62/93), the European Commission has sent a reasoned opinion to Greece concerning its treatment of requests for the refund of unduly paid taxes.

Between 1987 and 1992, Greece applied a special VAT scheme to the importation and distribution of petroleum products. VAT was not levied, as mandated by the Sixth VAT Directive, on each transaction in the distribution chain but rather as a single-phase tax upon importation of the goods into Greece.

All further transactions were treated as exempt from VAT. The operators involved in these transactions were therefore prevented from deducting VAT on related inputs.

Looking at a question referred by a national court, the ECJ ruled that Greece was precluded from applying the special scheme and that the operators involved in these transactions derived rights directly from the provisions in the Sixth VAT Directive. Consequently they were entitled to claim, with retroactive effect, the refund of the VAT. However, Greek case law effectively prevented the exercise of this right. The Commission has now sent a reasoned opinion to the Greek Government, formally requesting it to change the contested practice. Should it fail to do so, the Commission could refer Greece to the ECJ.

HUNGARY

State Aid: Ban on VAT Deductions

Under Hungarian law in force until 31 December 2005, input VAT on asset investments or activities financed from State aid was not fully deductible. Spain and France had previously implemented very similar measures to ban VAT deduction on investments financed from State aid, but on 6 October 2005, in the *Scott v Commission* case (C-276/03), the ECJ ruled these provisions to be against Community law. With effect from 1 January 2006, the VAT deduction ban relating to investments financed from State aid also ceased in Hungary, although not retrospectively.

Recently, the Hungarian Supreme Court (SC) delivered its decision in a case concerning the above mentioned deduction ban. The SC ruled that the prohibition of full VAT deduction relating to investments financed from State aid is against the Sixth VAT Directive (77/388/EEC Council Directive) and the Directive is directly applicable in Hungary since 1 May 2004 (when Hungary joined the EU).

Clearly, the decision of the SC is, therefore, of great significance. On the one hand, the decision creates a precedent when referring to the direct effect of EU Directives in a debate with the tax authorities in Hungary. On the other hand, the decision may also open up a potential deduction right for those who previously received State aid, but did not take steps to request a right to full deduction under the previous VAT legislation.

SPAIN

Refund of VAT to Taxable Persons

Spain has transposed the provisions of the Eighth VAT Directive on the recovery of VAT into its national legislation. However, investigation of a number of complaints led the Commission to conclude that VAT reimbursement to taxable persons not established in Spain sometimes take much longer than the prescribed period. It is settled case law that, by disregarding the six-month time limit for the refund of VAT to non-established taxable persons, a Member State is in breach of its obligations under the Eighth Directive. The Commission has, therefore, issued a reasoned opinion, formally requesting Spain to change its administrative practice in this field.

UNITED KINGDOM

Taxable Persons Not Established in the EU

The European Commission has decided to refer the UK to the ECJ for not complying with the provision of the 13th VAT Directive on the refund of VAT to taxable persons not established in the territory of the Community.

In December 2004, the United Kingdom amended its domestic VAT legislation transposing the 13th VAT Directive. As a result of the amendment, a taxable person established outside the EU is denied the right to recover VAT paid or due in the UK on goods or services insofar as they are used for the purpose of insurance or financial transactions supplied to customers established outside the EU. By contrast, a taxable person established in the UK is entitled, under UK domestic legislation, to recover VAT in such cases.

The European Commission, however, considers that the 13th VAT Directive, interpreted in connection with the relevant Community legislation, must be understood as allowing taxable persons established outside the Community to recover VAT borne in the UK on goods or services acquired and used for the purpose of insurance or financial transactions supplied to customers established outside the EU.

The UK Government has not amended its legislation following the reasoned opinion sent to it by the European Commission on 29 June 2007. ■

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