

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



Major developments

Harmful tax measures and VAT directive for insurance

At the Economic and Financial Affairs Council (ECOFIN) meeting on 3 June 2008, European Union (EU) Finance Ministers adopted the conclusions of a progress report on "harmful tax measures" and a proposal for a directive on the VAT treatment of insurance and other financial services, which are currently exempt from VAT.

The European Commission's progress report on harmful tax measures summarised the findings of the Code of Conduct Group (Business Taxation), set up in 1998 to examine how to bring about the elimination of situations of harmful tax competition on the basis of a voluntary code of conduct. The working group had long since identified 66 tax measures that have potentially harmful features (40 of them in Member States, 3 in Gibraltar and 23 in dependent or associated territories). EU Ministers have now agreed to accelerate the process of revising or replacing these measures. The working group will evaluate the "rollback" of tax measures deemed as "harmful" (i.e., where favourable tax treatment in one Member State unfairly attracts businesses from other Member States), and the monitoring of a "standstill" commitment by Member States not to introduce new measures that could be harmful. The group has been instructed to report back to the ECOFIN Council before 31 December 2008 when the French Presidency of the EU ends.

The Council also called on the French Presidency to report, by the end of the year, on progress towards a new directive aimed at clarifying and updating the definitions and rules governing insurance and financial services. Current legislation dates from the 1970s and is no longer fit for purpose in view of the changes that have taken place in the insurance and financial services markets. The Commission's proposal is aimed at increasing legal certainty for economic operators and tax administrations, reducing administrative burdens and reducing the impact of hidden VAT in the costs of service providers.

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Editorial

Though the Lisbon Treaty was stalled by Ireland's referendum, the EU continues to function and to affect tax legislation in all 27 Member States. Among direct tax developments, we report the decisions of the European Court of Justice (ECJ) in the *Lidl Belgium*, *Cartesio* and *Renneberg* cases.

In the indirect tax section, we cover draft guidelines for group VAT registration and proposed changes in VAT reporting requirements, as well as the pressure being put by the European Commission on various Member States to fully implement Community law on, for example, the application of VAT exemptions.

Matthias Roche

Focus on state aid

On 7 July 2008, the European Commission adopted the General Block Exemption Regulation (GBER), giving automatic approval to 26 categories of state aid for small businesses, regional development, training, innovation, job creation, risk capital and environmental protection. The GBER allows Member States to grant such aid without first notifying the Commission, thereby cutting red tape and speeding up change.

Introduction

The control of state aid has been an important preoccupation of the European Commission as it has sought to bring about fair competition and a level playing field for the Single Market. EU policy discourages forms of state aid that distort competition or seek to prop up declining industries. Yet financial incentives from government may sometimes be the only way to kick-start a new industry or bring about socially useful changes that market forces alone cannot provide. It is against this background that the Commission has adopted new measures to ensure that state aid is directed at those areas most beneficial to European society and economic competitiveness.

Encouraging entrepreneurship

About 80% of jobs in the EU are provided by small and medium-sized enterprises (SMEs), companies of 250 employees or less. Such companies, often family-owned or driven by one or more entrepreneurs, are an important source of new ideas. Encouragement for SMEs is, therefore, a crucial aspect of the so-called "Lisbon strategy" to promote job creation, innovation and sustainable economic growth. The Small Business Act, announced by the European Commission on 25 June 2008, gives a high priority to measures that will make life easier for small businesses.

The new block exemption

The GBER consolidates into one text and harmonises the rules previously existing in five separate Regulations, and enlarges the categories of state aid covered by the exemption. It will take effect 20 days after publication in the Official Journal (i.e., probably by the end of July 2008).

Aid measures not included in the GBER are not necessarily illegal. They will simply remain subject to the traditional notification requirement laid down in Article 88 (3) of the EC Treaty. The Commission will examine such notifications on the basis of the existing guidelines.

Certain industries are excluded from the GBER. These include agriculture, fisheries and aquaculture (which have separate arrangements); coal, shipbuilding, steel and synthetic fibres. Also excluded are undertakings subject to an outstanding order from the Commission to repay incompatible aid already granted.

Authorised aid categories

The types of aid authorised by the GBER, covering both SMEs and larger companies, are as follows:

- ▶ SME investment and employment; small enterprises newly created by female entrepreneurs; consultancy in favour of SMEs; SME participation in fairs; provision of risk capital;
- ▶ research and development; technical feasibility studies; industrial property rights costs for SMEs; research and development in the agricultural and fisheries sectors; young innovative enterprises; innovation advisory and support services; the loan of highly qualified personnel;
- ▶ training; recruitment of disadvantaged workers in the form of wage subsidies; recruitment and employment of disadvantaged or disabled workers; compensation for the additional costs of employing disabled workers;
- ▶ regional investment and employment; newly created SMEs in assisted regions;
- ▶ investment to go beyond Community standards for environmental protection; acquisition of transport vehicles that go beyond Community environmental protection standards; early adaptation to future environmental standards for SMEs; investment in energy saving measures; investment in high efficiency co-generation; investment in the promotion of energy from renewable sources; environmental studies; tax reductions to support the environment.

Note that the GBER includes ceilings on the amount of aid that can be granted, without prior notification, for different categories of support.

Other measures to support SMEs

Additional measures are expected soon, including, in particular, a new statute for a European Private Company, enabling SMEs to do business across the EU without having to set up subsidiaries in each Member State; a new proposal on VAT that will offer Member States the option to apply reduced VAT rates for locally supplied services, including labour-intensive services; and an amendment to the directive on late payments to ensure that SMEs are paid within 30 days.

Direct tax

Direct tax country updates - Austria, Belgium, Denmark

Country updates

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

Austria

International participation exemption

At the beginning of May 2008, the Austrian Administrative High Court made its decision regarding the international holding participation regime of the Austrian Corporate Income Tax Act (CITA), Article 10 (2). Foreign dividends are only tax exempt if the receiving company holds a share of at least 10% for at least one year, whereas domestic dividends are exempt without further requirements. The decision concerned the question of whether this differentiation is an infringement of the free movement of capital under the EC Treaty.

Since domestic portfolio dividends are tax exempt, while foreign dividends are only tax exempt if certain thresholds are met, foreign investments are being discriminated against, compared to domestic ones. The Austrian court ruled that this discrimination is clearly not in line with Article 56 EC and imposes an unjustified limitation on the free movement of capital, since participations which do not meet the criteria of Article 10 (2) CITA are fully taxed in the hands of the receiving company.

Nevertheless the Austrian court did not apply the exemption method to foreign portfolio dividends. It concluded from the *FII Group Litigation* case (C-446/04) that the ECJ regards the credit and the exemption method as equivalent. Thus, application of different methods to portfolio investments should not lead to further discrimination between domestic and foreign dividends. Since the Austrian court concluded that the application of the exemption method would have exceeded what was necessary to comply with EC law requirements, it stated that the credit method (credit of withholding tax and underlying tax) should be applicable to foreign portfolio dividends. According to the court, the extension of the exemption method to foreign portfolio dividends would only be at the discretion of the legislator.

Belgium

Failure to comply with Merger Directive

On 8 May 2008, the ECJ gave its decision in the *Commission v Belgium* case (C-392/07), concerning Belgium's failure to adequately transpose into national law Directive 2005/19/EC of 17 February 2005 (the Merger Directive). This amended Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States, in so far as it relates to 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 Merger Directive.

Article 2 (2) and (3) of the Directive 2005/19/EC 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 that Directive. The deadline for transposing the second part of the provisions of Directive 2005/19/EC expired on 1 January 2007.

Since Belgium failed to notify the national implementing measures by the deadline, the Commission sent a letter of formal notice asking Belgium to reply within two months. In the absence of an answer, the Commission decided to send Belgium a reasoned opinion in accordance with Article 226 EC. In the absence of a reaction from Belgium, the Commission brought the case before the ECJ. In its decision, the ECJ held that, by failing to adopt, within the prescribed period, the laws, regulations and administrative provisions necessary to comply with Directive 2005/19/EC, Belgium had failed to fulfil its obligations under that Directive.

Denmark

Income from investment funds

In a reasoned opinion, the European Commission has formally requested that Denmark change certain tax provisions. These provide that the income from investment funds is taxed at a preferential rate if the latter fulfils detailed requirements that are very difficult or impossible for foreign-based investment funds to fulfil.

The Commission considers the provisions incompatible with the freedom to provide services and the free movement of capital as guaranteed by Articles 49 and 56 of the EC Treaty and Articles 36 and 40 of the EEA Agreement.

The request takes the form of a reasoned opinion (2007/2002). If there is no satisfactory reaction to the reasoned opinion within two months, the Commission may decide to refer the matter to the ECJ. The Danish Minister of Taxation has not yet responded to the reasoned opinion.

Estonia

Changes in Estonian tax regime

On 16 April 2008, the amendments to the Income Tax Act, which will change the taxation of Estonian resident companies from 1 January 2009, were published in the State Gazette.

Since the accession of Estonia to the EU on 1 May 2004, there has been much discussion about Estonia's obligation to change its taxation principles for companies to bring them into line with, for example, the Parent-Subsidiary Directive. In the event, the long-expected changes turned out to be less radical than the models presented by the Minister of Finance in recent years. It could even be said that the changes in the taxation of Estonian companies are largely cosmetic.

In short, the present taxation system will, for the most part, continue in 2009. Taxation will, however, take place on an annual basis and the liability to make advance payments will be added. One substantial difference concerns the taxation of payments made in the case of decreasing the share capital, share payback or the liquidation proceeds of a legal entity. From 1 January 2009, such payments will be taxed like dividends at the level of the entity (rather than as a capital gain at the shareholder level).

Estonia's corporate tax system is unusual in that Estonian resident companies do not incur income tax at the time of earning their profit, but only when that profit is distributed. Actual and deemed profit distributions are taxed at the rate of 21% (20% in 2009) on the gross amount of the distribution. Such distributions are usually dividends but may include fringe benefits, gifts, donations, representation expenses and payments not related to the business of the company. In addition to such profit allocations ("distribution" is treated as a

wider concept than "direct dividend payments"), transfer-pricing rules apply against hidden distributions of profits.

Taxable base 2009

With effect from 1 January 2009, the taxable base for companies will be basically the same. i.e., it still includes dividends, hidden profit distributions and certain expenses that can be considered as allocations of profit, such as gifts, donations, representation expenses exceeding certain limits, and costs unrelated to business.

In one of the most significant changes applicable from 2009, payments upon redemption or return of shares, payments made to a person in case of a reduction in share capital exceeding monetary and non-monetary contributions (including share premium) and the proceeds of liquidation will also be equalised with dividends and taxed at the level of the company. Currently such payments are treated as capital gains and are subject to the relevant tax treaty provisions.

It should be noted that, in such cases, only those contributions that have been made to the capital of the company may be deducted (i.e., the purchase price of a holding is not deductible). This means that the scope of deemed dividends becomes wider and all the transactions with equity capital will be taxed at the payer's level, except income from the disposal of a holding, which will remain taxable at the level of the recipient.

Annual taxation

The period of taxation for entities will be the financial year and the calendar month will remain as the taxable period only in the case of fringe benefits. The tax return should be submitted and the tax paid within six months after the end of the financial year (i.e., by 1 July if the financial year is a calendar year).

Advance payments system

Companies are obliged to make two advance payments. One advance payment is equal to one third of the average amount of the taxable base during the three previous periods of taxation, multiplied by the tax rate applicable in that particular year. The advance payments make up two-thirds of the whole company's past average tax liability. Due dates for the advance payments will be the 10th day of the 10th month of the tax period and the 10th day of the 3rd month following the tax period (i.e., 10 October and 10 March if the financial

Direct tax country updates - Estonia (continued), Germany, Hungary

year is a calendar year). There are special transitional rules established for advance payments relating to the years 2010 and 2011.

Advance payments shall not be due if one payment does not exceed EEK 30,000 (about €1,917) and for the first period of taxation (i.e., for start-up companies and new permanent establishments). Based on a reasoned written application submitted by the taxable person, the tax authorities may reduce or cancel advance payments.

Payments made to non-residents

Starting from year 2009, dividends and licence fee payments made to non-residents are tax exempt in Estonia, as the recent rulings of the ECJ imply that any kind of withholding contravenes the EC Treaty if non-residents are discriminated against.

There have been some minor technical amendments regarding the taxation of profits distributed by a permanent establishment (PE). At present, a PE pays corporate income tax upon profit allocated to it that is taken out of the PE. The amendments do not change this situation.

Germany

Losses of foreign PEs

On 15 May 2008, the ECJ issued its ruling in the *Lidl Belgium* case (C-414/06), concluding that the principles established in the *Marks & Spencer* case (C-446/03) also apply to PEs. Consequently, it is not contrary to the freedom of establishment (Article 43 EC) for Germany to preclude the deductibility of losses incurred in the taxpayer's foreign PE in cases where the respective double tax treaty provides for the exemption method, if the PE's losses can be taken into account in future accounting periods.

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, on the basis of the double tax convention between Germany and Luxembourg, which provides for the exemption method with regard to income from PEs. Until 1998 German tax law allowed for a deduction of the losses combined with a recapture rule. As of 1999, such loss relief was no longer granted.

The ECJ referred to its reasoning in the *Marks & Spencer* case, stating that not all

three justifications established in *Marks & Spencer* have to be applicable cumulatively. In the *Lidl Belgium* case, the Court went on, 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 - were applicable and therefore sufficient to justify the treatment of the losses. Consequently, it was irrelevant whether or not the third justification, namely the risk of tax avoidance by routing losses to high-tax countries ('loss trafficking'), would actually be applicable with regard to PEs.

Regarding the principle of proportionality, the ECJ applied the *Marks & Spencer* reasoning, under which it is only contrary to the freedom of establishment if the head office, resident in one Member State, is prevented from claiming losses of a PE in another Member State, where the PE resident in that other Member State has exhausted the possibilities available in its Member State of utilising the losses for the current and previous accounting periods, and where there are no possibilities for those losses to be taken into account for future periods in its Member State.

The ECJ ultimately rejected the claim, considering that the Luxembourg PE of Lidl Belgium had offset its losses in a subsequent tax year with profits generated in that year.

Following the ECJ's decision, EU/EEA companies may claim for the deduction of losses incurred by their PEs which are established in another country within the European Union or the European Economic Area if the losses can no longer be taken into account in the Member State where the PE is located.

Hungary

Cross-border transfer of registered seat

Advocate General (AG) Poiares Maduro delivered his long-awaited opinion on the *Cartesio* case on 22 May 2008, supporting the transfer of a registered seat from Hungary to another Member State.

Background

The case concerns a Hungarian company, *Cartesio Bt.*, which intended to transfer its operational headquarters (registered seat) from Hungary to Italy, whilst remaining incorporated in Hungary. Under Hungarian domestic legislation, a company registered in Hungary does not have the right to transfer its registered seat to another

Direct tax country updates - Hungary (continued), Italy

country without first being dissolved in Hungary.

Cartesio lodged an appeal against the rejection of the request for the transfer of its registered seat, arguing that Hungarian company law treats cross-border situations less favourably than solely domestic situations. Cartesio also pointed out that Hungarian company law allows the transfer of a registered seat only within the territory of Hungary, despite the fact that both Hungarian private international law and the principle of freedom of establishment in European Community law would support their request as feasible.

During the Hungarian procedures, the Hungarian Court of Appeal at Szeged also submitted a preliminary ruling request to the ECJ, asking for its interpretation on the case.

AG's opinion

According to the AG's opinion of 22 May 2008, a company registered in a Member State should be allowed to transfer its registered seat to another Member State.

The AG agreed that provisions regarding the freedom of establishment are definitely applicable in this case. Accordingly, any provision preventing a company from transferring its registered seat from one Member State to another results in a restriction on freedom of establishment.

He added, however, that such a restriction may be justified under certain circumstances, e. g., the general public interest, the prevention of abuse or fraud, or the protection of the interests of minority shareholders, creditors or the tax authorities.

The AG also agreed that the Hungarian rules in question do favour the domestic situation without any grounds of justification. In the case at hand, he supported the view that the opportunity for cross-border seat transfer is completely excluded by the Hungarian law, which is incompatible with the principle of freedom of establishment, established under Community law.

He also emphasised that companies only exist by virtue of national laws, which apply different rules for incorporation. Despite this, the Member States are obliged to exercise their powers consistently with Community law.

The AG also underlined that in the period since the ECJ ruled on the well-known *Daily Mail* case in 1987 (C-81/87), case law on

the freedom of establishment of companies has developed significantly. In this context, cases such as *Centros* (C-212/97), *Überseering* (C-208/00), and *Cadbury Schweppes* (C-196/04) are particularly relevant.

Although the AG's opinion is not binding on the ECJ, it may affect its final judgment. The case before the ECJ only concerns the corporate law issue, but if the Court rules in favour of Cartesio, this would have an impact on exit taxation in the other Member States of the EU.

Italy

Preferential treatment for co-operatives

The European Commission has asked Italy, under EC Treaty state aid rules, for information regarding preferential tax regimes for co-operatives operating in the retail, distribution and banking sectors.

The main measures concerned by the Commission's analysis are:

- ▶ the deduction from taxable income of profits allocated to indivisible reserves under Article 12 law n. 904 of 1977;
- ▶ the deduction from taxable income of the co-operative bonuses (so called *ristorni*) distributed to members according to Article 12 Presidential Decree n. 601 of 1973;
- ▶ the tax reduction on interest paid to members for short-term deposits, under Article 23 law n. 49 of 1985 (reducing the withholding tax from 27% to 12.5%).

According to a preliminary assessment, the Commission seems to recognise the importance and valuable contribution of co-operatives to the economy. Co-operatives have certain specific features as they operate in the interests of their members and have a specific corporate model. Therefore co-operatives can be distinguished from profit-making companies, especially when they are purely mutual and generate revenues exclusively with members.

Nevertheless it appears also that co-operatives, despite their specificity, may also make profits from dealings with non-members and behave in the market in the same way as profit-making companies. The Commission considers that, under these circumstances, preferential treatment for co-operatives may entail State aid.

Direct tax country updates - Italy (continued), Netherlands

For that reason, the Commission seems to consider at this preliminary stage that the following may qualify as aid:

- ▶ the deduction from the taxable income of prevalently mutual co-operatives of the profits allocated to indivisible or divisible reserves corresponding to revenues generated from non-members of the co-operative. For large co-operatives and non-mutual co-operatives, the totality of the deduction could be considered as aid, because, where the members are not really involved in the co-operative, it seems more akin to a profit-making company.
- ▶ the tax reduction on interest paid to members for short-term deposits, because it does not relate to activities with members participating in the co-operative as such. Indeed, in providing interest-bearing loans to the co-operative, the members act as third party lenders and are not sharing economic risks with the co-operative.

On the other hand, the deduction from taxable income of the co-operative bonuses distributed to members seems not to be considered as aid, since the bonuses are generated only from exchanges between members.

It is relevant to point out that the tax regime of co-operatives has also been questioned by the Italian Supreme Court. In ordinance n. 3030 of 8 February 2008, the Italian judges asked the ECJ to verify whether the tax regime of co-operatives provided by Articles 12 and 13 of Presidential Decree n. 601 of 1973 (and other provisions) can be qualified as state aid.

Moreover the Italian Supreme Court asked the ECJ to verify if the use of co-operatives, especially in the banking sector, can be considered as an abusive practice when the only or main purpose is to take advantage of the peculiar tax regime applicable to this kind of entity.

If abusive behaviour is present, the automatic consequence, according to the Italian Supreme Court, would be the inapplicability of the preferential tax regimes for co-operatives. This case (*Amministrazione delle Finanze, Agenzia delle Entrate v Paint Graphos Scarl*) is now pending at the ECJ (C-78/08).

Netherlands

Withholding tax on foreign funds

On 20 May 2008, the ECJ issued its ruling

in the Dutch *Orange European Smallcap Fund NV* case (C-194/06), which was litigated by Ernst & Young. The case concerns the Dutch unilateral relief of foreign dividend withholding tax granted to Dutch zero-percent taxed investment funds. This relief distinguishes between the place where a domestic fund invests its capital, and the place of residence of the fund's shareholders.

According to the ECJ, the method of granting relief for foreign withholding tax is in conflict with the free movement of capital because of the extent to which it distinguishes between the place of residence of the shareholders of the fund. This conclusion also applies to the extent to which the shareholders of the fund are resident outside the European Community.

Deduction of interest by non-resident

On 25 June 2008, AG Mengozzi issued his opinion in the *Renneberg* case (C-527/06), concerning a public servant residing in his own dwelling in Belgium but earning almost his entire income from employment in the Netherlands. He had incurred financing costs relating to the Belgian real estate, costs which, effectively, could not be utilised in Belgium.

For Dutch tax purposes, the public servant qualified as a Dutch resident. Based on Dutch tax law only, the interest expenses could, therefore, have been taken into account when determining his taxable base. For the purposes of the Belgium-Netherlands tax treaty, however, he qualified as a resident of Belgium. The tax treaty by contrast, did not allow the Netherlands to take the interest expenses into account. Therefore, the deduction of the interest costs was eventually denied by the Dutch tax authorities. The question is whether this is in accordance with the EC Treaty freedoms.

After an elaborate analysis, the answer of the AG is "no". Basically, the fact that a Dutch resident is entitled to deduct the interest expenses from his earned income, whereas, in the case at hand, the non-resident public servant is eventually not entitled to such a deduction, constitutes a forbidden discrimination, according to the AG. In this respect, the EC Treaty obliges Member States which have entered into a bilateral tax treaty to avoid a situation where the position of a taxpayer is taken into account in neither Member State.

As a result, the Netherlands should take into account the financing costs relating to the Belgian real estate. This is irrespective of

the allocation of taxation powers as laid down in the tax treaty between the Netherlands and Belgium.

Slovakia

Referral to ECJ over state aid

The European Commission has decided to refer Slovakia to the ECJ concerning failure to implement the Commission's decision of 7 June 2006 ordering Slovakia to recover SKK 416.5 million (approximately €13 million) of illegal and incompatible state aid granted by the Tax Office Košice to Frucona Košice a.s. (see IP/06/754).

Competition Commissioner Neelie Kroes said: "The Commission will continue to be strict with Member States that fail to implement its state aid decisions. This is crucial to avoid unfair distortions of competition."

In June 2006, the Commission declared that a tax debt write-off worth SKK 416.5 million that the Tax Office Košice granted to Frucona, formerly one of the major producers of spirits in Slovakia, was incompatible with EC Treaty state aid rules and ordered Slovakia to recover the money from Frucona.

To carry out the Commission's decision, the Slovak authorities launched a court procedure to force the beneficiary to pay. However, the application for payment has been dismissed by the competent court. The Tax Office appealed against this judgment, but the appeal procedure is still pending and may last some time.

A Commission decision addressed to a Member State is binding on all the institutions of that state, including its courts. This implies that all the Member State's institutions involved in enforcing a decision must take all necessary measures to secure its immediate and effective application. Two years after the Commission's decision, Slovakia has not recovered the illegal and incompatible aid, and the measures so far undertaken have not led to any effective result. Therefore, the Commission has concluded that Slovakia has failed to comply with its decision of 7 June 2006.

This strict approach is in line with the State Aid Action Plan, which is designed to ensure the effectiveness and credibility of state aid control through better enforcement of Commission decisions (see IP/05/680 and MEMO/05/195).

Commission prohibits tax exemptions

The European Commission has decided under EC Treaty state aid rules not to authorise regional investment aid in the form of tax exemptions that could amount to around €2.9 million in favour of Alas Slovakia s.r.o. The Commission's in depth investigation, launched in December 2007, concluded that the proposed aid would not sufficiently contribute to regional development as to justify the distortions of competition that the granting of a selective advantage to a large company would have brought about. Neither the Slovak authorities, nor any other interested party responded to the doubts expressed by the Commission during its in-depth investigation. A negative decision was therefore inevitable. As the aid has not yet been disbursed, it is not necessary to order the recovery of the aid.

Competition Commissioner Neelie Kroes said: "The Commission has to take a strict line on aid which distorts competition without significantly contributing to regional development. As the Slovak Government did not respond to the investigation, the Commission had no option but to conclude that its original doubts were justified".

On 11 December 2007 the Commission opened a formal investigation, as it had doubts on the compatibility of the aid with the applicable 1998 EU guidelines on national regional aid. The 1998 regional guidelines allow state support for individual projects in certain disadvantaged regions, provided that the aid attracts new investment to these regions and that the distortion of competition and trade brought about by the aid is outweighed by its positive contribution to regional development (e.g., job creation). Moreover, as a general rule, regional aid should be granted under multi-sectoral aid schemes which are part of a regional development strategy with clearly defined objectives.

In this case the Slovak authorities planned to grant individual *ad hoc* aid to a single firm, Alas Slovakia, active in the extraction and processing of gravel and stone. It is the responsibility of the Member State to demonstrate that the project contributes to a coherent regional development strategy and that, having regard to the nature and size of the project, it will not result in unacceptable distortions of competition.

The Commission's initial investigation revealed that the aid would support activities in the extraction industry, where the location of sites is determined by the availability of natural resources. Alas is

Direct tax country updates - Slovakia (continued), Sweden

already operating in most of the locations relevant to its activity on the basis of long-term licences. Consequently, it was likely that the investment would take place even in the absence of the aid (i. e., there was no incentive effect) and that the aid would not contribute to regional development.

Moreover, the Commission questioned whether the very limited number of new jobs directly created could justify a level of aid that amounts to about seven years of wages per worker recruited. As a consequence, the Commission concluded that the expected contribution of the aid to regional development is outweighed by its negative effect on trade within the Single Market.

As neither the Slovak authorities, nor any third parties submitted comments during the in-depth investigation, the Commission could only confirm its initial doubts as expressed in its decision to open the formal investigation procedure.

Once any confidentiality issues have been resolved, the non-confidential version of the decision will be made available under reference number C 57/2007 in the State Aid Register on the Directorate General for Competition website. New publications of state aid decisions on the internet and in the Official Journal are listed in the State Aid Weekly e-News.

Sweden

Interest on inter-company loans

On 23 June 2008, the Swedish tax authority submitted a proposal to the Swedish government suggesting limitations on interest deductions for inter-company loans. The tax authority has identified several intra-group transactions where interest income has been accounted for in tax havens and at the same time interest deductions have been allowed in Sweden. This has led to a tax advantage for the Swedish company and the group.

The tax authority has previously attempted to challenge these transactions by using the Anti-Avoidance Act. However, the Swedish Supreme Administrative Court has ruled that the Anti-Avoidance Act is not applicable in these situations.

Therefore, the tax authority suggests that a Swedish company should not be allowed to deduct interest expenses on loans from an affiliated company in the following three specific situations:

- ▶ interest deductions on loans for intra-group acquisitions of shares, other share-based instruments and receivables;
- ▶ interest deductions on intra-group loans that have made it possible to pay a dividend to an affiliated company;
- ▶ interest deductions in respect of intra-group loans that have enabled capital contributions to be made to an affiliated company with the purpose of directly or indirectly acquiring shares in an affiliated company or for lending to affiliated companies.

The tax authority suggests that the proposal be introduced on 1 January 2009 and be applicable to interest expense incurred after 31 December 2008. If the suggested proposal is introduced, the limitations will be applicable to loans already in place.

The Swedish government has not yet taken any view on the tax authority's proposal. The proposal will be submitted to relevant parties for comment. While, at this stage, it is too early to comment on the likelihood of adoption, there are certain to be many comments on the proposal. Further developments will be reported in future editions of *EU tax news*.

Indirect tax

Latest EU developments

VAT: Group registration proposals

The European Commission's Taxation and Customs Union Directorate General (TAXUD) has recently drafted guidelines on the implementation of the VAT grouping option provided for in Article 11 of the VAT Directive (2006/112/EC).

The draft guidelines, presented to the VAT Committee last autumn, have received little publicity but could have important implications for some Member States, including Ireland and the UK which have long-standing VAT grouping schemes. Just over half of the 27 Member States have taken the option to introduce the concept of the single taxable person (or fiscal unity), otherwise known as group registration.

Proposed guidelines

The most important points in the proposed guidelines are as follows.

- ▶ Prior consultation with the Commission and VAT Committee are necessary before introducing a group scheme or any measures to prevent tax evasion or avoidance.
- ▶ Only taxable persons can join VAT groups and they must be established in the Member State concerned. This includes the PEs of foreign companies where they are situated in the territory but not the PEs of companies governed by national law and situated abroad.
- ▶ All transactions between a VAT group and PEs abroad (even if part of the same legal entity) are treated as transactions between two separate taxable persons and it makes no difference with which VAT group member the transactions take place.
- ▶ The financial, economic and organisational links that are a precondition of grouping must exist simultaneously and this excludes purely artificial constructions that have no economic logic.
- ▶ The VAT group is treated as a single taxable person, so that internal transactions within the group do not exist for VAT purposes and the group's external transactions are carried out by it (as a single taxable person) and constitute its output.

- ▶ The group and thus its members will be identified by a single VAT registration number. A company cannot join two VAT groups and all its activities form part of the group activities, except those carried out by establishments outside the territory.
- ▶ VAT grouping must be introduced across the board rather than for certain sectors, in order to preserve the principle of fiscal neutrality and prevent a possibility of illegal state aid.

One possible implication of the new guidelines is that anti-avoidance measures introduced without prior consultation with the VAT Committee may be invalid.

Proposed changes in VAT reporting requirements

As part of the effort to combat carousel fraud, the European Commission has proposed reducing to one month the frequency of recapitulative statements of intra-Community transactions. The deadline for the exchange of information between tax administrations of the Member States would also be reduced to one month. This information would have to be submitted by electronic file transfer.

Under the current provisions, recapitulative statements containing information on intra-Community supplies of goods are normally submitted by traders quarterly. Under the new proposals, which would come into effect on 1 January 2010, the recapitulative statements would have to be submitted monthly and would also include information on supplies of services in the Member State of the customer for which the customer is liable for payment of VAT. To do this, purchasers or customers carrying out such transactions for an amount higher than €20,000 per calendar year would be obliged to submit their VAT returns monthly.

The proposal contains provisions aimed at harmonising the rules for charging VAT on services in order to ensure that transactions are declared by the vendor and the purchaser during the same period, thus enabling the information submitted to tax authorities to be cross-checked more efficiently. Finally, certain complex procedures for submitting recapitulative statements would be simplified.

Latest EU developments (continued)

The Commission claims that the changes would only affect 4% of EU businesses registered for VAT and that the additional cost would be very small, except where the procedures for submitting recapitulative statements are unusually complicated. For some companies, however, such as those registered for VAT in numerous Member States, the extra costs could be considerable.

Application of VAT exemptions

The European Commission has decided to send formal notices to Austria, Denmark, Finland and Sweden about their legislation regarding the application of certain exemptions under the VAT Directive (2006/112/EC).

Under Article 132 of the Directive, certain public interest activities are VAT exempt. However, that provision does not give exemption from VAT for every activity performed in the public interest, but only to those that are listed and described in great detail in the Directive.

In its settled case law, the ECJ has stressed that all exemptions have to be interpreted restrictively, since they are exceptions to the general rule requiring VAT to be levied on any economic activity. Furthermore, exemptions applied by one Member State with no basis in the VAT Directive could lead to distortions of competition and would make it impossible to ensure that Member States contribute on an equal basis to the Community's own resources.

With regard to Austria, the European Commission considers that the scope of its VAT exemption rules should be broadened so as to encompass certain supplies by certain non-profit organisations to their members as well as supplies in connection with certain fund-raising events. Moreover, an exemption under the VAT Directive for supplies of services by independent groups of persons has not been implemented generally, but only with regard to certain professional activities. Also, according to the Commission, Austria's implementation of the exemption for supplies of certain services closely linked to sport or physical education by non-profit-making organisations to persons taking part in sport or physical education is too wide, since it is valid without restriction for all transactions by public interest associations, whose aim is to encourage physical exercise or the promotion of sports.

Finally, the VAT Directive contains an exemption for supplies of certain cultural services and the supply of goods closely

linked thereto. Austria appears to exempt all the business activities of theatres, museums, zoos, natural preserves and botanical gardens, going beyond what is allowed under the Directive.

Denmark exempts all supplies carried out by charitable or other non-profit-making associations in the course of their business. The Commission considers that such a generalised exemption goes beyond what is allowed under Article 132, which contains a restrictive description of the exempt activities and, in some cases, also makes the exemption conditional on the status of the person who is to carry them out.

Furthermore, Denmark applies a general exemption for goods supplied by second-hand shops, if the surplus is used entirely for charitable purposes or otherwise for public interest purposes, provided that the shop only sells second-hand goods that have been received free of consideration and that the shop only employs voluntary unpaid staff. None of the exemptions in Article 132 covers such supplies.

Under Swedish VAT law, the definition of "economic activity" is directly linked to the definition and criteria of economic activity under national income tax law. In the Commission's view, these criteria are irrelevant and potentially misleading from the point of view of VAT and constitute an infringement of the VAT Directive. Because of differences in the definition of economic activity, there is discrimination between non-profit making organisations.

The Commission points out that the activities carried out by non-profit making associations and religious congregations would in most cases be exempt under Article 132 of the VAT Directive. Failing that, Sweden could implement a special scheme for small enterprises, which is allowed under the VAT Directive. Entities under this scheme would not be obliged to apply VAT on their supplies of goods or services.

A similar situation arises in Finland, where, under the national Income Tax Act, only those entities of public interest that are liable for income tax for commercial activities are considered taxable persons for VAT purposes. Other entities of public interest are excluded from VAT. Moreover, several of the exemptions listed in Article 132.1 of the VAT Directive have not been implemented into Finnish legislation.

The Commission's reference numbers are 2007/2453 (Austria), 2007/2312 (Denmark), 2007/2371 (Finland), and 2007/2311 and 2008/2002 (Sweden).

Country updates

Indirect tax country updates - Italy, Netherlands

Italy

Conditions for group tax system

On 22 May 2008, the ECJ delivered its judgment on the case of *Ampliscientifica* (C-162/07). There was no AG opinion prior to the judgment.

Background

The parties to the case were, on the one hand, *Ampliscientifica Srl* and *Amplifin SpA* and, on the other hand, the Ministry of Finance (*Ministero dell'Economia e delle Finanze*) and the Revenue Authority (*Agenzia delle Entrate*). The case concerned an additional VAT assessment addressed to *Amplifin* in respect of the years 1990 and 1991. *Ampliscientifica* and *Amplifin* were incorporated under Italian law and were part of the *Amplifon* group, which was engaged in the research and development of new scientific instruments.

The dispute in the initial proceedings arose from concerns regarding tax declarations submitted by *Ampliscientifica* for 1990 and by *Amplifin* for 1990 and 1991. *Amplifin* held 99% of the shares in *Amplaid SpA*, which in its turn held more than 50% of the shares in *Ampliscientifica*, which was incorporated in February 1989. In addition, *Amplifin* held more than 50% of the shares in *Ampliare Srl* which was incorporated in November 1990.

Amplifin made an entry in its accounts transferring a VAT debt of *Ampliscientifica* for the tax year 1990, stating that, according to a national decree of 1979, it formed a tax group with the latter company. *Amplifin* did the same regarding *Ampliare Srl* with a debt for the tax year 1991. However, the Italian decree of 1979 prescribes that such handling is possible if the control over the subsidiary companies had existed from the beginning of the calendar year preceding the year in which the declaration was made (1990 and 1991, respectively). Because this condition had not been met, the tax authorities refused the declarations of *Amplifin SpA*.

ECJ decision

In its preliminary ruling, the ECJ declared that a Member State can apply the rules from Article 4, fourth paragraph of the Sixth VAT Directive (the rules regarding fiscal unity) only after consultation by that Member State with the VAT Committee. On this aspect the Italian authorities did not act on the basis of the foreseen procedure.

Nonetheless, the ECJ ruled that it was for the national court to determine whether or not the conditions of Article 4 are met by the national rules.

Furthermore, the ECJ ruled that the principle of fiscal neutrality did not preclude a national provision which simply treated taxpayers wishing to opt for a mechanism to simplify VAT declarations and payments differently according to whether the parent company has held more than 50% of the shares of the entity with which it has been linked since at least the beginning of the calendar year preceding that in which the VAT declaration was made, or which satisfies that condition only after that date. Whether or not the national legislation at issue in these proceedings constituted such provision was also for the national court to determine. Moreover, according to the ECJ, neither the principle prohibiting the abuse of rights nor the principle of proportionality precludes such legislation.

Netherlands

VAT exemption for provision of personnel

The European Commission has submitted a reasoned opinion to the Netherlands (2006/4674), asking it to amend its legislation with regard to the VAT exemption applied to the provision of personnel in certain sectors.

Background

The Netherlands applies a VAT exemption for the provision of personnel in the socio-cultural sector, the health sector and the education sector. The VAT Directive provides for a general exemption in these sectors. According to the ECJ, the exemptions in the VAT Directive are to be strictly interpreted, since they constitute exceptions to the general principle of levying VAT on all services supplied by taxable persons. The Commission believes that the provision of personnel in the sectors in question in this case is not covered by the general exemptions granted by the VAT Directive and adds that the VAT exemption for the socio-cultural sector, the health sector and the education sector is too wide an application by the Netherlands.

Furthermore, public corporate bodies providing personnel to EU regions are not considered as VAT taxable persons under Dutch legislation and, as a consequence, the services they supply are not subject to VAT in the Netherlands. In the Commission's view, these public corporate bodies do act like private bodies when they provide

**Indirect tax country updates -
Netherlands (continued),
Poland**

personnel and should, therefore, qualify as taxable persons subject to VAT.

Poland

VAT on cross-border passenger transport

In a reasoned opinion (2007/4139), the European Commission has formally requested that Poland bring into line with the VAT Directive its national rules on the application of VAT to cross-border passenger transport services (i.e., buses registered abroad).

Under the VAT Directive, cross-frontier transport services are subject to VAT in each Member State for the distance travelled therein. Poland has introduced a particular VAT scheme for cross-border passenger transport services supplied on an occasional basis by means of buses registered abroad. This scheme, which applies to the part of the transport taxable in Poland, entails basically the following:

- ▶ the bus driver is asked to pay the tax in a customs office when the bus enters Poland;
- ▶ the amount of the tax is established for each passenger at 7% of PLN 285 (i.e., 19.95 Polish zloty);
- ▶ the transport company is not allowed to recover any VAT borne in Poland.

Thus, the scheme leads to VAT due in Poland being collected through payment at the border of an amount calculated on the basis of an average taxable amount per traveller.

However, the scheme applied by Poland deviates from the Community rules since, according to the VAT Directive:

- ▶ VAT due by the supplier of the transport service must be declared and paid by means of a VAT return and not through a one-off payment at the border;
- ▶ the amount of the tax due results from the application of the VAT rate to the part of the total consideration paid for the transport service, which is proportional to the distance travelled in Poland;
- ▶ the transport company must be allowed to deduct VAT borne in Poland in the periodical return.

Furthermore, the Polish provisions lead to fiscal cross-border controls, thus contravening the essential principles of the common system of VAT. For these reasons,

the Commission has formally requested Poland to change its legislation.

VAT exclusions for certain motor vehicles

The European Commission has sent a reasoned opinion to Poland (2005/4855), asking it to align with the VAT Directive its national rules governing exclusions of the right to deduct VAT due or paid on certain specific motor vehicles and on the fuel acquired to propel them.

According to the VAT Directive (Article 176), Member States that joined the European Community after 1 June 1979 may retain all the exclusions of the right to deduct VAT provided for under their national laws on the date of their accession.

The ECJ has ruled that, after accession, those Member States are entitled to modify those exclusions only in so far as the modification entails their abolition or at least the reduction of their scope. By contrast, no modification leading to a wider scope of the exclusion is allowed.

In the Commission's view, the VAT Directive does not allow a Member State that joined the Community after 1 June 1979 to enlarge the scope of the exclusions of the right to deduct VAT upon accession by means of an amendment to the previous rules entering into effect on the very same day of accession. Any amendment entering into force upon accession can only result in the abolition or at least reduction of the exclusions of the right to deduct VAT previously applied.

The exclusions of the right to deduct VAT applied in Poland on acquisitions of motor vehicles and fuel were amended both at the time of accession (1 May 2004) and at a later date (22 August 2005). As a result, certain specific categories of motor vehicles (and the fuel acquired to propel them), which under the preceding legislation were subject to the normal rules of deduction, have fallen within an exclusion of the right to deduct. As they were applied in Poland immediately before accession, this entails that, at least in certain cases, the scope of the exclusions has been widened in breach of Community Law.

For this reason, the Commission has formally requested Poland to change its national rules.

In addition, on the basis of Article 234 of the EC Treaty, a preliminary question on this same subject has already been referred to the ECJ by a Polish court in the currently pending *Magoora* case (C-414/07).

Indirect tax country updates - Portugal, Spain

Portugal

Discriminatory suspension of car tax

In a reasoned opinion (2002/4285), the European Commission has requested that Portugal change its law regarding the difference in car tax suspension periods granted to "registered" and "recognised" vehicle traders. The Commission considers that the difference in treatment leads to discrimination against vehicles produced in Member States other than Portugal.

Under the Portuguese Vehicle Tax Code (*Código do Imposto sobre Veículos*), a "registered trader" (i.e., a person normally involved to a certain extent in the production, admission or importation of vehicles) may hold a vehicle on a tax-suspended basis for a time limit of three years, while a "recognised trader" (i.e., a person normally involved in the buying and selling of vehicles but not fulfilling the conditions to qualify as a registered trader) is allowed a time frame of six months.

It also follows from the legislation that vehicles manufactured in Portugal may only be supplied by "registered" traders, who may hold such vehicles on a tax-suspended basis for a maximum period of three years, while vehicles produced outside Portugal, whether new or old, may be traded by both "registered" and "recognised" traders.

The disadvantageous six-month time limit for suspension of the tax would thus never apply to new cars manufactured in Portugal. The Commission believes that this situation discriminates against pmanufactured outside Portugal and therefore infringes Article 90 EC.

Spain

Deduction of VAT on imports

Spain has been sent a reasoned opinion by the European Commission (2006/4670), requesting it to comply with the VAT Directive with regard to its national rules governing the right to deduct VAT on imports. According to the VAT Directive (Articles 167 [in connection with Article 70], 178 and 179), the right to deduct VAT due on the importation of goods:

- ▶ arises at the time when the goods are imported;
- ▶ requires, in order to be exercised, that the taxable person be in possession of an import document specifying him as consignee or importer, and stating the amount of VAT due or enabling that amount to be calculated.

However, under the Spanish VAT legislation in force prior to 1 January 2008, the right to deduct VAT due on the importation of goods:

- ▶ arises at the time when the taxable person pays the deductible VAT to the customs authorities (Article 98 of the Spanish VAT law);
- ▶ requires, in order to be exercised, that the taxable person be in possession of a document showing that the VAT has already been paid to the customs authorities (Article 97 of the Spanish VAT law).

In the opinion of the European Commission, the Spanish legislation is in breach of the VAT Directive because the conditional payment of the VAT by the importer to the customs authorities went far beyond the provisions of the VAT Directive.

Subsequently, the Spanish authorities amended Article 98 of the Spanish VAT law as of 1 January 2008. However, Article 97 thereof remained unaltered, and the result was that, under the rules presently in force, and contrary to the VAT Directive, deduction of VAT due on imports is still conditional upon the importer being in possession of a document attesting to the fact that VAT has already been paid to the customs authorities. For this reason, the Commission has formally requested Spain to change its national rules.

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