

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

# EU tax news



## Major developments

### First report on implementation of the Savings Directive

On 15 September 2008, the European Commission issued its first report on the implementation of Directive 2003/48/EC of 3 June 2003 on the taxation of savings income in the form of interest payments (the Savings Directive). The report is the first to be prepared under Article 18 of the Directive, which requires the Commission to report to the Council of Economics and Finance Ministers every three years on the operation of the Directive and, where appropriate, to propose any amendments needed to best ensure the effective taxation of savings income and to remove undesirable distortions of competition.

The Directive came into effect in most Member States on 1 July 2005, with Bulgaria and Romania implementing on 1 January 2007. Special transitional arrangements were put in place for Austria, Belgium and Luxembourg regarding the exchange of information.

The Commission reported that, broadly speaking, the transposition and implementation of the Directive by Member States went smoothly and on time. The first economic evaluation of the Directive's impact revealed no significant changes in the patterns of investment or the structure of savings, and there was no perceived abandonment of the products covered by the Directive. It seems, from the Commission's analysis, that the Directive has been effective within the limits set by its scope. In its report, however, the Commission advocated amendment of the Directive in the following areas:

- ▶ Beneficial ownership
- ▶ Definition of paying agent
- ▶ Treatment of financial instruments equivalent to those explicitly covered
- ▶ Procedural aspects

*(continued overleaf)*

#### In this issue

**Major developments** 1

**Editorial** 1

**Focus on tobacco taxation** 3  
Proposal to increase excise duties

**Direct tax** 4  
Country updates

**Indirect tax** 12  
Latest EU developments  
Country updates

**Contacts** 15  
Direct tax and indirect tax

#### Editorial

In contrast to the recent turmoil in financial markets, the last two months were quiet in terms of tax news. In this issue, we report on the first triennial review of the Savings Directive and look briefly at proposed changes to tobacco taxation.

Elsewhere, we report on several recent cases involving the abuse of law principle and withholding taxes on dividends, as well as judgments affecting the tax consolidation regime in France, Italy's tax amnesty, taxation in Spain's Basque region and the treatment of VAT roundings. Other items include the Commission's continuing efforts to extend the regime for reduced rates of VAT.

Matthias Roche

# Major developments (continued)

*A summary of the problems identified by the European Commission in its first triennial review of the Savings Directive and the amendments it wants to make to the Directive in order to close potential loopholes and improve operational effectiveness.*

## **Uncertainty over beneficial ownership**

The Commission found that individuals resident in the EU could circumvent the Directive by using an interposed legal person or arrangement situated in a non-EU country not covered by the Directive.

*Proposed solution:* to close this loophole, the report proposed that paying agents should be asked to use the information already available to them under anti-money-laundering provisions about the actual beneficial owner (s) of a payment made to a legal person or an arrangement.

## **Unclear definition of paying agent**

Under the Directive, some entities are obliged to apply the Directive when they receive an interest payment, by acting as a paying agent. However, the definition of "paying agent" has generated uncertainty.

*Proposed solution:* To clarify the situation, the Commission recommended moving to an approach based on a "positive" definition of intermediate structures to be charged with obligations to act as a "paying agent upon receipt". The Commission suggested a definition establishing a positive list of all entities and arrangements that are not taxed on their income under the general rules for taxation applicable in the Member States in which the entity or arrangement is resident.

## **Treatment of financial instruments equivalent to those explicitly covered**

The review found that the Directive could be circumvented by rearranging one's financial affairs in such a way that income that is equivalent to interest from debt claims remains outside the formal definition of interest payment.

*Proposed solution:* Extend the scope of the 2003 Directive to income from securities that are equivalent to debt claims; and life insurance contracts whose performance is strictly linked to income from debt claims or equivalent income.

With regard to investment funds, the Directive only covers income obtained through undertakings for collective investment in transferable securities authorised in accordance with Directive 85/611/EC (the UCITS Directive).

*Proposed solution:* Replace the reference to Directive 85/611/EEC with a reference

to the registration of the undertaking or investment fund or scheme in accordance with the rules of any of the Member States.

## **Procedural aspects**

According to the consultation, the following improvements would be desirable for the sake of effectiveness and clarity.

- ▶ The identification of beneficial owners and the establishment of their country of residence.
- ▶ Some procedural elements of the definition of interest payments.
- ▶ The information reporting carried out by the paying agent.
- ▶ Facilitation of the access of beneficial owners to the exception to the withholding tax procedure.

The Commission also urged the Council to look at whether the procedure for the exception to the withholding tax on the basis of a certificate submitted by the beneficial owner could be abolished. This procedure provides less detail to the state of residence of the beneficial owner and is less practical for the latter than the alternative procedure of voluntary disclosure and exchange of information.

The Commission's first formal report on the Savings Directive has shown that the Directive is effective within the limits set by its scope and "has also had indirect, non-measurable positive results in enhancing taxpayers' compliance with their obligations to declare interest income". The aim of the Commission's proposed amendments is to close possible loopholes, while limiting the administrative burden on paying agents.

On the basis of their report, the Commission services have started working on an amending proposal to be submitted to the Council as soon as possible. The issue will be taken up again at the meeting of the Economic and Financial Affairs Council (ECOFIN) in October 2008.

# Focus on tobacco taxation

*On 16 July 2008, the European Commission issued proposals for changing the way tobacco products are taxed in the Member States. The principal objectives are to reduce smuggling and deter smoking. The main impact will be felt in Eastern Europe where prices of cigarettes will rise sharply. A Commission report spells out the relevant facts and a draft directive proposes the necessary legislative changes. The Commission wants the new regime in place by 2014 in most Member States and throughout the EU by 2016. However, it will not be easy to get approval by the Council of Ministers of the changes envisaged.*

## **Introduction**

Tobacco taxation policy tries to balance revenue requirements with public health concerns. Different countries in the European Union (EU) have assessed this balance in different ways and a wide variety of tax levels are in place, despite efforts by the European Commission to create a level playing field. The expansion of the EU from 12 Member States in 1986 to the current 27 Member States has greatly increased EU disparities in cigarette prices. In an attempt to bring order into this important but rather chaotic market, the European Commission has drafted a new directive on the taxation of cigarettes and other tobacco products. The draft directive foresees a gradual increase in the EU minimum taxation levels on cigarettes and fine-cut tobacco up to 2014. It also updates the definitions of different types of tobacco products so as to remove loopholes that allow certain cigarettes or fine-cut tobacco to be presented as cigars, cigarillos or pipe tobacco and thus benefit from lower taxes.

## **Price differences and smuggling**

The UK and Ireland currently have the highest cigarette prices in the EU, followed by Sweden and France. Cigarettes in the UK are about six times as expensive as those sold in, for example, Latvia. All of the former Eastern Bloc countries that joined the EU in recent years have much cheaper tobacco products than those in Western Europe. One of the undesirable results has been a rapid increase in the amount of intra-EU smuggling that takes place (in addition to smuggled and counterfeit cigarettes from non-EU countries).

It is estimated that the total market penetration of non-domestically taxed consumption represented about 13% of the tobacco market in the EU-25 in 2004. In a number of main markets, this figure was over 20%. The problem of smuggling has continued to grow, with the annual loss of revenue to the UK government, for example, estimated at over €5 billion.

## **Commission proposals on cigarettes**

Under current EU rules, excise duties levied on cigarettes must account for at least 57% of the retail selling price, and must be at least €64 per 1000 cigarettes, for products falling under the "most popular price category" in that country. The concept of

the "most popular price category" (MPPC) was designed over 30 years ago, when national markets were dominated by one brand that was clearly 'most popular'. Today's markets are more dynamic with many competing brands and regular price changes. In order to create more transparency and to ensure a level playing field for manufacturers, the Commission proposes replacing the MPPC with a weighted average price of all cigarettes for determining the tax base. In order to underscore health objectives, it will be combined with a monetary minimum tax applicable to all cigarettes.

The current percentage of 57% will be increased to 63% of the weighted average price and the rate of €64 will rise to €90 for all cigarettes by 2014, under the new proposal. It is estimated that this will contribute to a 10% decrease in tobacco consumption in most Member States within the next five years.

The Commission also proposes giving Member States more flexibility in tobacco taxation. This will be ensured by abolishing the existing rules which forbid Member States to levy a minimum excise tax higher than 100% of the total excise on the most popular price category. Furthermore, the Commission proposes to widen the band of the specific component of the excise duty from 5%-55% to 10%-75%.

## **Other tobacco products**

Notwithstanding the fact that cigarettes and fine-cut tobacco have different characteristics, they are competing products and are equally harmful for health. The gap between the current level of taxation for cigarettes and fine-cut tobacco (sometimes hand-rolled cigarettes are taxed 30% less than ordinary cigarettes) gives rise to product substitution. Between 2002 and 2006, the consumption of cigarettes decreased by more than 10% but, in parallel, the consumption of fine-cut tobacco increased by around 10% in the EU-25. To address this problem, the Commission proposes a partial alignment of the minimum rate for fine-cut tobacco to the minimum rate for cigarettes.

In addition, definitions of non-cigarette products are to be amended so as restrict the application of the lower minimum rate to traditional cigars and cigarillos.

# Direct tax

## **Direct tax country updates: Belgium, France**

### **Country updates**

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

#### **Belgium**

##### **Usufruct and Parent-Subsidiary Directive**

On 3 July 2008, Advocate General (AG) Eleanor Sharpston gave her opinion in the Belgian case of *Les Vergers du Vieux Taupes SA* (C-48/07). In the AG's view, dividends received by a usufructuary should be eligible for the exemption based on the Parent-Subsidiary Directive (90/435/EEC).

The applicant, Les Vergers du Vieux Taupes SA, a Belgian company, purchased usufructuary rights over shares in the company Narda SA (Narda) in June 1999 for a period of ten years; another company, Bepa SA (Bepa), acquired the legal ownership of the shares. After the ten-year period Bepa will become full owner of the shares. There were no shareholding links between the vendors of the shares on the one hand and the applicant and Bepa on the other. The applicant wished to acquire the shares in Narda in the short term with a view to optimising its financial resources and increasing its product range. Bepa wished to acquire the shares in the medium or long term for longer-term strategic, economic and financial reasons, by increasing the number of its subsidiaries.

In 2000, 2001 and 2002, the applicant sought to deduct from its taxable basis dividends received from Narda. The Belgian tax authorities proposed to rectify the applicant's tax declarations for those years and tax the dividends on the basis that the usufructuary right held by the applicant was not a "holding in the capital" of Narda. The applicant lodged objections but these objections were dismissed by the Belgian tax authorities in January 2004. The applicant successfully challenged their decision and, on appeal, the matter was referred to the European Court of Justice (ECJ)

In arriving at her opinion in this case, the AG observed that the Parent-Subsidiary Directive aims at facilitating cross-border co-operation between companies by

eliminating the double taxation of dividends.

AG Sharpston pointed out that the Directive does not aim only to encourage groups in the conventional company law sense. In the AG's view, the Directive also requires Member States to grant the advantageous tax treatment when the dividends are received by one company by virtue of a right of usufruct, whilst legal ownership remains with another company.

Meanwhile, Belgium has changed its participation exemption regime and tightened certain conditions. Under the current legislation, in order to benefit from the participation exemption, the parent company must hold a participation in the subsidiary's capital of at least 10% or an acquisition value of at least €1,200,000.

In addition, the shares must qualify as "financial fixed assets" (as opposed to "short term investments") and be held in full ownership for an uninterrupted period of at least one year. In the light of the relaxed interpretation of the AG, the conditions that the shares must qualify as financial fixed assets and be held in full ownership seem contradictory to the Parent-Subsidiary Directive.

#### **France**

##### **Tax consolidation regime**

On 4 September 2008, AG Juliane Kokott released her opinion in the case of *Société Papillon v Ministère du budget, des comptes publics et de la fonction publique* (C-418/07). This case relates to the prohibition of tax consolidation of French lower-tier subsidiaries held through non-French EU companies.

According to Article 223A of the French tax Code, a company is not eligible for the tax consolidation regime unless 95% of its shares are held by the parent company, directly or through other companies included in the tax consolidated group. Since a foreign company is not subject to corporate income tax in France, it cannot be part of a consolidated group and thus its French subsidiary cannot be consolidated (unless the foreign company has a permanent establishment in France and the shares of the French companies are in the permanent establishment assets).

## **Direct tax country updates: France (continued), Germany**

Whereas the Paris Administrative Court of Appeal has decided that this unequal treatment is justified by the coherence of the French consolidation tax system, since the interposition of a company which is not subject to the same rules between members of a tax consolidated group would prevent the aggregation of their results, the French Supreme Administrative Court has preferred to refer the issue to the ECJ.

In her opinion, AG Kokott concluded that Article 223A constitutes a restriction to the freedom of establishment.

The AG admitted that such a restriction may eventually be justified by the coherence of the French tax consolidation system since, as explained by the French tax authorities, the tax consolidation of the French lower-tier subsidiary of a foreign subsidiary might allow a double deduction of the losses incurred by the French subsidiary - once at the level of the subsidiary and once at the level of the French parent company.

Moreover, in the AG's view, it is for the national court to determine if the prohibition of tax consolidation of French lower-tier subsidiaries held through foreign subsidiaries does not go beyond what is necessary to ensure this coherence and attain the objectives pursued. However, she expressed her doubts and stated that the French tax authorities could have implemented less restrictive measures in order to ensure such coherence, such as requiring the parent company to provide certain information and/or relying on the Mutual Assistance Directive.

Finally, anticipating a pending ECJ case on the possibility of including a foreign subsidiary in a Dutch fiscal unity, the Dutch and German governments argued that existing French tax consolidation rules should be justified by the necessity to preserve the allocation of the power to impose taxes between Member States. The AG dismissed this justification on the grounds that this would be an issue in regard to the extension of tax consolidation to foreign subsidiaries whereas the *Papillon* case relates to the consolidation of French lower-tier subsidiaries.

### **Germany**

#### **Tax on dividend distributions**

On 26 June 2008, the ECJ rendered its decision in the *Burda* case (C-284/06), concerning a German levy of corporate income tax on dividend distributions. The preliminary question put to the ECJ in this

case was whether the German legislation at hand was in line with Council Directive 90/435/EEC of 23 July 1990 (the Parent-Subsidiary Directive) on the common system of taxation, applicable to parent companies and subsidiaries of different Member States, and with Articles 43 and 56 of the EC Treaty.

Burda GmbH, a company incorporated under German law and with its place of effective management in Germany, distributed dividends in equal shares to its shareholders, a company named RCS with its place of effective management in the Netherlands, and another German company named Burda International. Under the German legislation, this distribution was taxed at the rate of 30% and only Burda International received a certificate of deductibility of corporation tax in respect of the profit distribution by Burda.

The order for reference also shows that, following a tax audit, it was established that Burda had distributed profits in an amount greater than the taxable income. The tax office (*Finanzamt*) therefore reduced the various available capital and reserve items subject to corporate income tax at the full rate and set off the distributions which, after reduction, were no longer covered by the taxed available capital and reserves, against the capital and reserves. That set-off gave rise to increases in corporation tax for the two years in question in the main proceedings and, therefore, to the issuing, in particular, of two amended tax assessments. The main question then was whether this increase constituted a withholding tax within the meaning of the Parent-Subsidiary Directive.

The ECJ generally followed the Opinion of AG Mengozzi issued on 31 January 2008, and concluded that the aforementioned corporate income tax additional levy does not constitute a "withholding tax" since the third condition for the existence of a withholding tax within the meaning of Article 5(1) of the Parent-Subsidiary Directive (i.e., that the taxable person must be the holder of the shares) had not been fulfilled.

The ECJ observed that the corrective mechanism at issue in the main proceedings was intended to ensure that the amount of tax paid by the company making the distribution corresponds, after correction, with the amount of the tax credit erroneously granted to the shareholder. Such a corrective mechanism is not discriminatory since it is applicable to a company resident in Germany, regardless of

**Direct tax country updates:  
Germany (continued), Greece**

whether it is a subsidiary of a parent company which is also resident in Germany or of a parent company resident in another Member State.

That assessment is not weakened by the fact that, for non-resident shareholders, the tax levied on the company making the distribution becomes definitive in the sense that the increase in the tax burden imposed on the company making the distribution is not compensated for by the allocation of a corresponding tax credit.

In the absence of any unifying or harmonising Community measures, Member States retain the power to define, by treaty or unilaterally, the criteria for allocating their powers of taxation, particularly with a view to eliminating double taxation.

In the case at hand, which concerns the cross-border distribution of profits, it is, in principle, not for the Member State in which the subsidiary is resident to prevent that economic double taxation but for the Member State in whose territory the parent company is resident to grant either exemption or a tax credit.

It follows from the foregoing that Article 43 EC must be interpreted as not precluding the German corrective mechanism consisting of the levy of corporate income tax on dividend distributions to companies resident in other Member States.

## **Greece**

### **Dividend withholding tax**

A new draft law has been presented to the Greek Parliament amending the regime for dividend taxation in Greece.

In particular, dividends distributed by Greek SAs (the legal form equivalent to an SpA, AG or NV in other countries) are no longer free of any withholding taxation. Instead, they are subject to a 10% withholding tax that applies to all recipients, Greek or foreign, individuals or legal entities. This withholding tax is not imposed on dividends distributed to EU parent companies covered by the Parent-Subsidiary Directive.

Likewise, a 10% withholding tax applies to dividends distributed by foreign SAs to individuals who are resident in Greece. In other words, Greece is introducing the same taxation regime for individuals with regard to both local and foreign dividends. These changes are being introduced in response to pressure from the European Commission to bring Greek law into line with EU requirements.

However, Greece remains in breach of EU legislation with regard to the taxation of profits distributed by EPEs (Greek limited liability companies, i.e., the legal form equivalent to an srl, GmbH or BV) and the profits of foreign limited liability companies distributed to individuals or legal entities resident in Greece. In the former case, an exemption from taxation applies, regardless of whether the recipient is Greek or foreign, an individual or a legal entity, while in the latter case, full taxation is imposed with a credit only for any tax withheld upon distribution, unless the Parent-Subsidiary Directive applies, in which case the underlying corporate tax is credited too.

### **Real estate transfer tax**

The European Commission has issued a reasoned opinion (reference 2007/4319), requesting Greece to amend the rules that give permanent residents in Greece a tax exemption on the real estate transfer tax for their first residential property purchase, but do not grant the same exemption to first-time residential buyers who do not yet live permanently in Greece but intend to do so in the future.

Furthermore, Greece is requested to abolish its discriminatory rules that, under certain circumstances, allow a real estate transfer tax exemption to Greek nationals living abroad when they are acquiring their first residential real estate in Greece, but do not allow the same exemption to foreign nationals.

In the Commission's opinion, Greece is granting more advantageous tax treatment to persons living permanently in Greece and purchasing their first property there, compared with those who merely acquire such real estate for investment purposes.

This difference in treatment may be justified by promoting the acquisition of housing and deterring speculation. However, the same treatment must be granted to all first-time residential buyers who intend to live in the property, whether they are already permanently living in Greece at the time of purchase or not.

The Commission considers that the exemptions provided in the Greek legislation constitute a violation of the discrimination ban, as well as of the free movement of persons and the freedom of establishment laid down both in the EC Treaty and in the EEA Agreement.

## **Direct tax country updates: Ireland, Italy, Netherlands**

### **Ireland**

#### **Interest on savings certificates**

On 18 September 2008, the European Commission announced that it had formally requested Ireland to remove what it perceives to be a discriminatory form of treatment resulting from a tax exemption for interest on savings certificates issued by the Irish Government and a potential tax exemption for interest and gains derived from certain government securities and state-guaranteed securities by persons not ordinarily resident in Ireland. Interest on similar foreign certificates and securities is not tax exempt. The Commission's request to the Irish Government took the form of a reasoned opinion (reference 2007/2061).

Bearing in mind the precedent of the ECJ's ruling on 26 September 2000 in the case of *Commission v Belgium* (C-478/98), the Commission takes the view that the Irish provisions dissuade taxpayers from investing in similar financial instruments issued in other EU Member States or European Economic Area (EEA) countries and are thus contrary to the free movement of capital rules of Article 56 of the EC Treaty and Article 40 of the EEA Agreement. If there is no satisfactory reaction to the reasoned opinion within two months, the Commission may decide to refer the matter to the ECJ.

### **Italy**

#### **Interpreting the abuse of law principle**

In various cases concerning VAT, such as *Halifax* (C-255/02) and *Part Service* (C-425/06), the ECJ stated that an abusive practice exists to the extent that the transactions concerned, notwithstanding formal application of the conditions laid down by the relevant provisions of the Sixth VAT Directive and of national legislation transposing it, result in the accrual of a tax advantage the grant of which would be contrary to the purpose of those provisions.

This abuse of law principle has been broadly interpreted by the Italian Supreme Court:

- ▶ In decision n. 8772 of 4 April 2008, the abuse of law principle, as indicated by the ECJ, was also considered applicable for direct tax purposes so that the Italian tax authorities were not bound to accept transactions whose main aim was to obtain a tax advantage.
- ▶ In ordinance n. 3030 of 8 February 2008, the Italian court asked the ECJ to confirm whether the use of co-operatives, especially in the banking

sector, could be considered an abusive practice when the only or main purpose of such co-operatives was to take advantage of the particular tax regime applicable.

This wide interpretation of the abuse of law principle is also present in a more recent decision (n. 21170 of 6 August 2008) in which the Italian Supreme Court clearly stated that the abuse of law principle must be seen as a general anti-avoidance provision immanent in the Italian tax system, even before the entry into force of the specific anti-avoidance provisions contained in Article 10 law n. 408/90, which was then replaced by Article 37 bis Presidential Decree n. 600/73.

Italian commentators have questioned whether the said interpretation of the Italian Supreme Court complies with ECJ case law, since the abuse of law principle is also used in purely domestic situations.

### **Netherlands**

#### **Cross-border fiscal unity**

On 11 July 2008, the Dutch Supreme Court handed down its ruling in a case where the main question is whether a cross-border fiscal unity between a Dutch parent and a foreign subsidiary should be allowed on the basis of EU law. After a long argument, the Supreme Court concluded that the answer to this question cannot be derived from existing ECJ case law.

For this reason, the court has referred the matter to the ECJ by way of a preliminary question. The Supreme Court wants to know whether the condition that the fiscal unity is only applicable to companies that are subject to Dutch profits tax is in conflict with EC freedom of establishment principles.

#### **Anti-abuse rule under Merger Directive**

On 11 July 2008, the Dutch Supreme Court also gave its decision in a case regarding the Merger Directive. The case concerns a business merger between related parties. Although the merger as such is business-motivated, an artificial route has been chosen in order to avoid Dutch real estate transfer tax. The question is whether the tax authorities are, for that reason, allowed to deny the business merger facility under Dutch corporate income tax law. Since the Dutch transfer tax is not mentioned in the Merger Directive as one of the taxes to which this Directive applies, the Dutch Supreme Court has its doubts and has therefore referred this question to the ECJ.

**Direct tax country updates:  
Netherlands (continued), Norway**

**Dutch dividend withholding tax**

On 8 August 2008, the Dutch Supreme Court handed down a ruling relating to the compatibility with EC law of the Dutch dividend withholding tax. In this case, a UK company owned all the shares in a Dutch company. The Dutch company made dividend distributions that were taxed with Dutch dividend withholding tax. However, if the parent had been established in the Netherlands, the dividend distribution would have been tax exempt. In accordance with the cases of *Denkavit* (C-170/05) and *Amurta* (C-329/05), the Dutch Supreme Court ruled that the dividend taxation was in conflict with the EC Treaty freedoms, unless it could be established that the Dutch withholding tax could be credited under the applicable Dutch/UK tax treaty. The latter issue is now expected to be investigated by the lower Dutch Court.

**Inheritance tax law**

On 11 September 2008, the ECJ gave its ruling in the *Arens-Sikken* case (C-43/07). This case concerns the Dutch inheritance tax due upon an inheritance of Dutch real estate. According to the last will of the deceased, who lived in Italy, the taxpayer heir was obliged to pay, on a proportionate basis, a sum of money representing part of the value of the Dutch real estate to each of his four children.

Based on Dutch inheritance law, this obligation could not be deducted from the tax base, i.e., the value of the Dutch real estate inherited by the taxpayer. The Dutch Supreme Court has asked the ECJ to decide whether this is compatible with the free movement of capital. The ECJ has now answered this question in the negative.

According to the ECJ, the Dutch rule constitutes a forbidden restriction of the free movement of capital to the extent it imposes a higher tax burden than would apply if the real estate had been left by a Dutch resident. The fact that the Member State of residence of the deceased (Italy) may grant relief by way of a unilateral tax credit (instead of by means of a double tax convention) does not alter that conclusion.

**Norway**

**New savings tax deal under negotiation**

In the near future, the European Commission is expected to be given authorisation to hold talks with Norway on a new bilateral deal to introduce tax measures on savings that would be equivalent to EU rules on savings tax.

Norway has officially written to the Commission expressing interest in applying such rules to the savings of EU citizens held in Norway and the savings of Norwegian citizens held in the EU. The aim is to introduce a model covering mutual exchange of information, thus going further than the transparency deal negotiated between the EU and Switzerland.

The EEA Agreement, to which Norway is a signatory, does not allow EU savings tax rules to be adopted. This needs to be done through a bilateral deal which, so far, five non-EU countries and ten Member States' overseas territories have negotiated.

**Time limit for refund of withholding tax**

Based on Norwegian case law, the ECJ ruling in the *Manninen* case (C-319/02) and Article 40 of the EEA Agreement, the Norwegian tax authorities have accepted that the withholding tax on inbound dividends and the withholding tax on outbound dividends to companies in the EEA violated the EEA Agreement. The domestic rule was changed in 2004, taking into account that, as a main rule, no withholding tax is levied on dividends to companies resident within the EEA. (Note that from 1 January 2008, there are additional substance requirements.)

However, some EEA companies may also have paid Norwegian withholding tax in 2004 and later years, for example by failing to meet the strict documentation requirements for enjoying a zero rate. This might be the case for investment funds, unit trusts, pension funds, holding agents, etc. These taxpayers must apply for a refund of the Norwegian withholding tax. The question is which time limit applies in Norway for that purpose.

On 15 April 2008, the Norwegian Regional Court (*Iagmannsretten*), giving its ruling in the *Vesta* case, established important guidelines in this respect. The Regional Court decided that the time limit for changing the assessment is three years (and not ten years), which is counted from the end of the income year. The Regional Court held that if the taxation has been based on incorrect application of the EEA Agreement, the case must be qualified as wrongly applying the tax provisions and, therefore, the applicable time frame is three years for submitting such claims. The Court did not agree with the taxpayer that the unlawful assessment was based on an incorrect understanding of the facts, in which case a ten-year time limit applies.

Based on the decision of the Regional Court,

## **Direct tax country updates: Norway (continued), Portugal**

the assessment for the income year 2005 can be changed if a taxpayer submits a letter to the tax authorities asking for a change of the assessment by 31 December 2008. The case at hand was about the taxation of inbound dividends in the hands of a Norwegian company, but it may be assumed that the same time limit would apply in respect of a foreign EEA company applying for a refund of withholding tax.

An additional question is how foreign companies can ask for a refund of Norwegian withholding tax paid in 2004 or earlier years.

Foreign companies that should have been granted a zero-rate withholding tax may file a claim with the Norwegian courts to cover 2004 and earlier years by either filing a civil refund claim or filing a damage claim.

Note that a civil refund claim must be submitted within one year after the taxpayer "should have known" about the refund claim, whereas a damage claim should be filed within three years after the taxpayer "should have known" about the claim. It is not yet clear when the taxpayer "should have known" about the claim, i.e., when the time limit starts. It is also unclear whether a damage or refund claim will be accepted by the Norwegian courts.

These are among the issues in five pilot cases before the Regional Court, three of which are being litigated by Ernst & Young. There are approximately 100 suspended cases that are waiting for the outcome of the pilot cases. Owing to the uncertainty regarding when the time limit starts, we recommend that taxpayers who want to secure their claim should make an application as soon as possible.

### **Portugal**

#### **Tax representatives for non-residents**

Under Portuguese tax law, non-resident taxpayers who obtain taxable income in Portugal have to appoint a fiscal representative to represent them before the Portuguese tax authorities and to guarantee the fulfilment of their fiscal duties. The aim of this requirement is to guarantee payment of taxes and prevent tax evasion, which are recognised public interest requirements.

However, based on the ECJ's judgment of 7 September 2006 in the *N* case (C-470/04), the Commission takes the view that this general obligation imposed on non-residents to appoint a fiscal representative goes beyond what is necessary to ensure these objectives, being

a restriction to the free movement of persons and the free movement of capital under Articles 18 and 56 EC and Articles 36 and 40 EEA.

Accordingly, the European Commission has formally requested Portugal to change the provisions, under which non-resident taxpayers must appoint a tax representative in Portugal. The request takes the form of a reasoned opinion (the second step of the infringement procedure provided for in Article 226 of the EC Treaty). If the Portuguese Government does not take the necessary steps to comply with its request, the Commission may decide to take Portugal to the ECJ.

#### **Withholding tax for non-residents**

According to Portuguese tax law, non-resident entities providing services in Portugal are subject to a withholding tax (15%) on the gross amount of their income, whereas domestic providers are taxed only on their net profits.

The Commission considers that these rules are incompatible with the EC Treaty, which guarantees the free provision of services, as they are likely to dissuade foreign service providers from providing services in Portugal, and might dissuade Portuguese clients from buying services from foreign providers. The Commission also considers that there is discrimination to foreign service providers established in Cyprus (which has not signed a Double Tax Convention with Portugal).

The Portuguese Government has argued that taxation on the basis of gross income does not apply to service providers resident in Member States with which Portugal has signed a Double Tax Convention (i.e., all Member States except Cyprus). In addition, Portugal has argued that, in the case of taxation on the gross income, the difference in the tax base might be offset by the difference between the rate applicable to resident entities (25%) and the final withholding tax rate (15%) applied to non-resident entities. The Portuguese Government also considers that the measures are necessary to combat tax fraud. The Commission has now decided to refer the matter to the ECJ.

#### **Taxation of lottery winnings**

Under Portuguese law, income earned in Portugal in the form of prizes or winnings from competitions, games or gambling is subject to taxation. However, an exemption applies to lottery winnings from Euromilhões and Liga dos Milhões, lotteries

**Direct tax country updates:  
Portugal (continued), Spain,  
Sweden**

and games organised by the Santa Casa da Misericórdia de Lisboa, an entity carrying out activities of social interest.

The Commission considers that such an exemption constitutes a discrimination prohibited by the EC Treaty, as the favourable treatment is not open to other EU entities carrying out similar activities of social interest.

Thus, the Commission has sent Portugal a formal request to amend such discriminatory rules. The request takes the form of a reasoned opinion (the second step of the infringement procedure provided for in Article 226 of the EC Treaty). If the Portuguese Government does not take the necessary steps to comply with its request, the Commission may decide to take Portugal to the ECJ.

### **Spain**

#### **Basque region tax and state aid**

On 11 September 2008, the ECJ issued its preliminary ruling on the question that was posed by the Supreme Court of the Basque Country regarding the state aid character of the Basque Country's corporate income tax. The judgment concerned the joined cases of *Unión General de Trabajadores de la Rioja v Juntas Generales del Territorio Histórico de Vizcaya y otros* (C-428-06 to C-434-06).

The Spanish regions bordering the Basque Country had asked the Spanish court to consider the new tax legislation, adopted by the Basque Country within its scope of competence, as null and void, because, in their view, it constituted state aid within the meaning of Article 87.1 of the EC Treaty.

This new Basque tax legislation lowered the corporate income tax rate to 32.5% (while the applicable tax rate in the rest of Spain was 35%) and provided a 10% tax credit for investments in new fixed assets related to the trading activity of the company. This credit does not exist under the Spanish tax system.

In the context of the actions for annulment in the main proceedings, the Spanish court asked the ECJ whether the Basque Country tax legislation, which is of general application, is to be regarded as "selective" and subject to the provisions of Articles 87 EC and 88 EC, solely on the ground that this tax legislation applies exclusively to the territorial jurisdiction of an infra-state authority with autonomy in tax matters.

The ECJ provided some guidance as to how the criteria provided in its previous

judgment in the Azores case (C-88/03) were to be applied to the Basque Country. Let us recall that, in the Azores case, the ECJ concluded that only infra-state bodies with institutional, procedural and economic autonomy may adopt their own tax system without giving rise to state aid. In its judgment on the Basque Country case, the ECJ made it clear that the judicial review of the infra-state legislation did not amount to a lack of institutional autonomy, and nor did a certain amount of co-ordination and co-operation with the central authorities amount to a lack of procedural autonomy.

However, the ECJ did not reach a conclusion on whether the transfers of income and services between the central and the infra-state authorities meant that the Basque Country did not have economic and financial autonomy. The ECJ simply provided additional interpretative criteria that the Spanish court should take into account when finally deciding on the issue. Thus, the issue remains unresolved and has now been passed back to the Supreme Court of the Basque Country.

### **Sweden**

#### **Discriminatory exit tax provisions**

Under Swedish Law, an exit tax is levied on unrealised capital gains and deductions made for untaxed reserves if the company is no longer taxable in Sweden upon a change of its seat or place of effective management; or, in the case of a permanent establishment, if it ceases its activities in Sweden or transfers its assets to another Member State.

In the European Commission's view, these provisions are incompatible with the freedom of establishment as guaranteed by Article 43 of the EC Treaty and Article 31 of the EEA Agreement. The Commission's opinion is based on the EC Treaty as interpreted by the ECJ in its judgment of 11 March 2004 in the case of *Lasteyrie du Saillant* (C-9/02), as well as on the Commission's Communication on exit taxation (COM [2006] 825 of 19 December 2006).

Therefore, the Commission has formally requested Sweden to change the tax provisions imposing an exit tax on companies ceasing to be taxable in Sweden. The request takes the form of a reasoned opinion (2007/2372). If there is no satisfactory reaction to the reasoned opinion within two months, the Commission may decide to refer the matter to the ECJ.

**Direct tax country updates:  
Sweden (continued),  
United Kingdom**

## United Kingdom

### Cross-border loss compensation

The European Commission has sent the United Kingdom Government a formal request to properly implement the ECJ judgment of 13 December 2005 in the *Marks & Spencer* case (C-446/03), with regard to cross-border loss compensation.

In the national legislation meant to implement the *Marks & Spencer* ruling, the UK imposes conditions on cross-border group relief that make it virtually impossible for taxpayers to benefit from the relief.

The Commission considers that this is contrary to the EC Treaty and has, therefore, issued a 'reasoned opinion' under Article 226 of the EC Treaty, formally requesting the UK to change its legislation.

In the *Marks & Spencer* judgment, the ECJ ruled that the UK ban on cross-border loss relief was disproportionate, insofar as it denied loss relief where a non-resident subsidiary had exhausted all possibilities for relief in its state of establishment. Following this ruling, the UK should, in principle, grant relief for definitive losses of a subsidiary established in another Member State.

However, although the original legislation has been amended, the UK still imposes conditions on cross-border group relief which, in practice, make it impossible or virtually impossible for the taxpayer to benefit from tax relief pursuant to the ECJ's judgment in *Marks & Spencer*. This concerns the following points in particular.

- ▶ There is an unnecessarily restrictive interpretation of the condition that there should be no possibility of use of the loss in the state of the subsidiary (paragraph 7 of Schedule 18A of the Income and Corporation Taxes Act (ICTA) 1988).
- ▶ The date for determining whether the condition is met that there should be no possibility of use of the loss in the state of the subsidiary is set immediately after the end of the accounting period in which the loss arises (Part 1, paragraph 7(4), of Schedule 18A ICTA 1988).
- ▶ The time limit to claim for group relief for losses made by subsidiaries established in other Member States is set at twelve months (extended in the case of enquiries by the Revenue) after the filing date for the corporate tax return of the claimant company (Schedule 18, paragraph 74, of the Finance Act 1998).

- ▶ The legislation states that it applies only to losses incurred after 1 April 2006 (Part 3 of Schedule 1 of the Finance Act 2006).

According to the Commission, these conditions make the new legislation incompatible with the freedom of establishment, guaranteed by Articles 43 and 48 of the EC Treaty and Articles 31 and 34 of the EEA Agreement.

If the UK does not reply satisfactorily to the reasoned opinion (2007/4026) within two months, the Commission may refer the matter to the ECJ.

# Indirect tax

## Latest EU developments

### VAT: application of reduced rates

On 7 July 2008, the European Commission made a proposal to change the VAT Directive (2006/112/EC) so as to provide Member States with the flexibility to apply reduced VAT rates for some specific services on a permanent basis.

In the absence of clear directions from the Council in response to the Commission's Communication of 5 July 2007 regarding the full revision of the system of reduced rates, the proposal only seeks to deal with issues that require urgent action while, at the same time, seeking to provide the same possibilities to all Member States. At present, for example, 11 Member States apply a reduced rate to restaurant services while the 16 remaining Member States cannot. A similar situation of derogations exists for labour intensive services.

The proposal does not include a general review of these derogations nor does it widen the scope of reduced rates for environmental or energy saving purposes. On this last point, the Commission is currently carrying out a number of studies concerning the possible use of reduced rates for energy saving materials or energy efficient goods and services in accordance with the request formulated by the European Council in March 2008. The Commission is expected to present the results of its analysis, accompanied by relevant proposals, in November 2008.

The sectors concerned are mainly labour intensive services and locally supplied services in, for example, restaurants.

The housing sector will no longer be limited to services linked to a social policy, as it is currently, but will be broadened to include the supply and construction of all housing, as well as all related services such as renovation, maintenance, cleaning, etc.

The supply of restaurant and catering services is also included, but not the supply of alcoholic beverages.

It is proposed that labour intensive services should be permanently included in the list of services eligible for reduced rates. Moreover, the category is broadened to other locally supplied services of a similar nature. That is:

- ▶ Minor repair of tangible movable goods, such as shoes, clothes, computers,

watches and bicycles (but not other forms of transport).

- ▶ Cleaning and maintenance services of all these goods and, in this case, other means of transport are included.
- ▶ Domestic care services (e.g., home help and care of the young, elderly, sick or disabled).
- ▶ All personal care services (including hairdressing, beauty services, etc.).
- ▶ Gardening services.
- ▶ Renovation and maintenance services provided to places of worship, cultural heritage and historical monuments, as recognised by Member States.

In other words, the proposal only covers those areas where there is sufficient evidence that reduced rates do not create problems for the proper functioning of the internal market. The scope of the proposal is therefore limited and most of the services in question are already eligible for a reduced rate but only in a limited number of Member States and only for a limited period running until 2010. The proposal does not alter the principle that the application of reduced rates is optional for Member States.

### ECJ decision on VAT roundings case

On 10 July 2008, the ECJ gave its ruling in the case of *Ahold NV v Staatssecretaris van Financiën* (C-484/06). This case, which concerned the rounding-off of VAT amounts by a Dutch supermarket giant, reached the Dutch Supreme Court and subsequently was referred by that court to the ECJ.

In the calculation and declaration of VAT due on sales, Ahold normally calculated the amount on the basis of the total amounts on each till receipt and rounded its VAT amounts on an arithmetical basis to the nearest Eurocent. For two of its branches, however, Ahold deployed a different method, which calculated VAT for each sold item, rather than for each receipt. The amounts were rounded to the nearest Eurocent but, in the total balance, this resulted in a lower amount of VAT to be paid by the two branches. The branches therefore requested a refund of the balance. This was challenged by the Dutch tax authorities.

The Dutch Supreme Court referred the case

## **Latest EU developments (continued)**

to the ECJ to see, first, whether this issue was a matter of EC law covered by the VAT Directives or whether it fell under the sole responsibility of the Member States. If the ECJ decided that it was a matter for Community law, a second question arose: namely, whether Member States should permit rounding-off of VAT amounts per article, even if an invoice or tax return concerned multiple articles.

Regarding the first question, the ECJ ruled that this is not a matter of Community Law, and hence should be governed by national law. It noted that Member States should observe the principles underpinning the common system of VAT and in particular the principles of fiscal neutrality and proportionality.

With regard to the second question, the ECJ ruled that EC legislation does not carry a specific obligation for a Member State to permit taxable persons to round down the VAT due per item. The VAT amount to be collected, therefore, needs to correspond exactly to the amount of VAT declared on the invoice or paid by customers.

### **Italian VAT amnesty conflicts with EC law**

On 17 July 2008, in the case of *EC v Italian Republic* (C-132/06), the ECJ ruled that the VAT amnesty scheme introduced by the Italian Government in its Finance Law for 2003 was in conflict with the obligations of Member States under the Sixth VAT Directive and Article 10 of the EC Treaty.

The case had been referred to the ECJ by the European Commission, which argued that the Italian amnesty scheme was in conflict with Article 2 of the Sixth VAT Directive. The amnesty scheme allowed taxpayers, who had failed to account for amounts of various taxes such as VAT between 1997 and 2001, to escape scrutiny if certain declarations were made and certain sums were paid immediately.

According to Article 2 of the Sixth VAT Directive, all transactions have to be taxed with VAT. However, Italy challenged the arguments of the Commission by saying that the effect of the amnesty was not a general and indiscriminate renunciation of all verification; that only a limited number of persons liable for VAT have had recourse to the amnesty arrangements; that it had been extremely productive in terms of tax recovered; and that it had, therefore, been a judicious use of limited resources, falling within the latitude necessarily accorded to Member States.

The ECJ dismissed this argument by ruling that Italy had failed to fulfil its obligations under the Sixth VAT Directive in conjunction with Article 10 of the EC Treaty, by explicitly providing a general waiver of verification operations on taxable transactions effected in the course of a series of tax years.

### **EU split over proposed VAT cuts**

On 12-13 September 2008, EU finance ministers held an informal meeting in Nice to discuss how to respond to the recent financial instability and slowdown in economic growth. One of the issues debated was the possible economic benefits of a reduction in VAT rates for certain types of small business activity in sectors such as restaurants, hotels and hair dressing.

Whereas France and several other EU Member States supported the initiative to call for an increase in the number of economic areas that benefit from the EU's lowest VAT rate of 5%, several other countries strongly opposed such an initiative, arguing that it would distort competition between different economic sectors and countries.

The French push for approval of a lower VAT rate was backed by Belgium in the belief that the introduction of lower VAT rates could have a significant positive impact on employment, by creating jobs in restaurants for instance.

Opposing such a move, Germany argued that there was no evidence that a lower VAT rate would positively affect the job market. If surrounding countries were to lower their VAT rate, it would have a negative impact on Germany in terms of competition. Germany also expressed concern about the budgetary implications of a reduction in tax revenue. Germany would, therefore, be likely to block an extension of the reduced VAT rate if it came to a vote.

The European Commissioner for Taxation, Lázló Kovács, on the other hand, spoke in favour of a lower VAT rate in restaurants, arguing that this would not distort competition and could give a boost to jobs.

Despite the current lack of progress, the Member States seem to be willing to debate the issue of lower VAT rates. However, implementing a change would not be easy, since all 27 Member States would need to agree to such an amendment of tax law.

EU ministers will return to this subject in October when a detailed report on the implications of reduced rates will be presented to them by the Commission.

## Indirect tax country updates: Greece, Ireland

### Country updates

#### Greece

##### Transposition of VAT directives

On 18 September 2008, the European Commission issued to Greece two reasoned opinions (2008/0073 and 2008/0277) for failing to notify the following transposition measures:

- ▶ On the one hand, under Directive 2006/69/EC of 24 July 2006 relating to certain measures to simplify the procedure for charging value added tax and to assist in countering tax evasion or avoidance, and repealing certain Decisions granting derogations.
- ▶ On the other hand, under Directive 2006/112/EC of 28 November 2006 on the common system of value added tax.

Directive 2006/69/EC brings in more effective and transparent rules allowing Member States to adopt anti-fraud measures more flexibly than before, while at the same time repealing certain derogations granted to individual Member States. The Directive entered into force on 31 December 2007.

Directive 2006/112/EC is a recasting of Directive 77/388/EEC, once commonly referred to as the "Sixth VAT Directive", to rationalise into a single statutory instrument the various amendments made to that Directive over time. This Directive entered into force on 1 January 2008.

If no response is received from Greece within the next two months, the Commission may decide to refer these two cases to the ECJ.

#### Ireland

##### Abuse of law rule upheld

Giving its judgment in the case of *Edward Cussens and others v Brosnan, Inspector of Taxes* (2008, IEHC 169), the Irish High Court has recently ruled on the application of the "abuse of law" concept to a "lease in, lease out" structure used to minimise VAT.

The case concerned a partnership that owned and developed a site for holiday homes. Shortly before the sale of the houses, the partners entered into a 20 year one month lease with a connected company, which then leased the properties back to the partners for a two year period. The lease and leaseback were then surrendered before the sale to third parties.

The Court looked at the question of whether the leases and their subsequent surrender should be disregarded for VAT purposes as an abusive practice within the meaning of European law. The Court noted that the "abusive" concept had been part of ECJ jurisprudence for some time and that it was a principle of "general application applying to all branches of European law, including taxation".

This position was contrasted with the strictly literal approach taken to the interpretation of direct taxation provisions, for example in *McGrath v McDermott, Inspector of Taxes* (1988, IR 258).

The Court observed that "Income tax is entirely based on Irish legislation and is not obligated by our membership of the European Union. The courts in interpreting domestic legislation do not apply any general principle whereby, what might be called, unworthy transactions, which have no apparent benefit apart from being a tax avoidance mechanism, are analysed in terms of the substance of the transaction."

However, EU measures should not be "set at nought through legal transactions that may be apparently valid on their face but which are entered into with the essential aim of undermining the supremacy of European legislation".

Noting the ECJ decisions in the cases of *Halifax* (C-255/02) and *van Binsbergen* (C-33/74), the Court reiterated that "No taxpayer is obliged to choose, where there is a choice of two transactions, that economic activity which yields to the Revenue Commissioners, or other national taxation body of a Member State, the highest amount of taxation."

Nevertheless, the Court concluded that the transactions entered into by the partnership were entirely contrary to the correct interpretation of the Sixth VAT Directive and operated to undermine "the foundational certainty of the exemptions provided for in national law and under the Directive."

It is not known if the decision will be appealed to the Supreme Court.

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