

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



In this issue

Major developments 1

Editorial 1

Direct tax 2
Country updates

Indirect tax 10
Country updates

Contacts 15
Direct tax and indirect tax

Major developments

Council approves Eurofisc system to combat VAT fraud

At their meeting in Luxembourg on 7 October 2008, the European Economics and Finance Ministers (ECOFIN) agreed to the proposal put forward by the expert group on anti-tax fraud strategy to establish a new system called "Eurofisc" to improve administrative co-operation between the Member States of the European Union (EU).

In parallel, the European Commission intends to present a proposal in November 2008 for the recasting of Regulation (EC) No. 1798/2003 of 7 October 2003 on administrative co-operation in the field of VAT, including provisions to enable Eurofisc to function properly.

The Council set the following guidelines for Eurofisc:

- ▶ Eurofisc would be a decentralised network for the exchange of information on VAT fraud between the Member States, with each of its tasks being co-ordinated.
- ▶ Eurofisc would observe four general principles: (1) the freedom for each Member State to participate in any of the network's tasks; (2) active participation in the exchange of information; (3) the confidentiality of the information exchanged; and (4) no additional burden on operators.
- ▶ Eurofisc would not have legal personality. Its functioning would be organised by agreement of the participating Member States, with the support of the Commission. Its tasks would be carried out by liaison officials expert in tax fraud.
- ▶ Eurofisc's tasks initially would be to provide a multilateral early warning system for combating tax fraud and to co-ordinate the exchange of information and the work of participating Member States in acting on warnings received.

Editorial

Uncertainty continues to overshadow global financial markets and economic activity, adding to pressures for greater international co-operation and regulatory oversight. Political change is in the air too.

Meanwhile, in the tax field, national courts are increasingly taking their lead from decisions made in the European Court of Justice (ECJ). In this issue, we report on direct tax cases in nine countries. Examples include Truck Center, KRW, Renneberg and Vodafone 2. We also cover indirect tax developments in Cyprus, Denmark, the Netherlands and the United Kingdom.

Matthias Roche

Direct tax

Direct tax country updates: Belgium

Country updates

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

Belgium

Belgian withholding tax on interest

On 18 September 2008, the ECJ's Advocate General (AG) Juliane Kokott released her opinion in relation to the Belgian withholding tax regime on interest. She decided that the Belgian regime is not contrary to the EU freedom of establishment when providing a withholding tax exemption for interest paid to a Belgian resident company but not for interest paid to companies in other EU Member States.

According to Belgium's domestic tax law, interest paid by a Belgian company to another Belgian company benefits from a withholding tax exemption (Article 107, §2, 9° of the Royal Decree implementing the Income Tax Code). Interest paid by a Belgian company to a non-resident company (including EU Member State companies) cannot benefit from this exemption.

Facts of the case

Truck Center SA (Truck Center), a Belgian resident company, received an interest-bearing loan from a Luxembourg resident company, which also held a 48% participation in Truck Center. Withholding tax was due on the interest, but the company did not withhold or pay any withholding tax. The domestic withholding tax was not reduced under the Belgium-Luxembourg double taxation treaty, as the treaty allows a withholding tax of 15%, where the interest is paid to a company that holds a direct or indirect participation with voting rights of at least 25% in the company paying the interest.

The Belgian tax authorities, therefore, claimed the interest withholding tax due. Truck Center, however, did not agree with the Belgian tax authorities, arguing that the withholding violates the free movement of capital under the EC Treaty. The Court of Appeals of Liège decided to refer to the ECJ the question of whether or not the Belgian interest withholding exemption violates the free movement of capital.

Decision of the AG

First, the AG considers that the ECJ should rather examine the case in light of the freedom of establishment, since:

- ▶ The Belgian rule, combined with the double tax treaty, requires a 25% shareholding in order to allow the levy of withholding tax.
- ▶ The Luxembourg company receiving the interest in the present case owned 48% of the shares in the Belgian company.

Second, according to the AG, the different treatment of Belgian resident lenders and non-resident lenders cannot be deemed discriminatory, since both categories are not comparable in connection with the collection of tax liabilities. The taxation of non-resident lenders through a tax levied at source is an effective and proportionate measure to take into account this different position. At the relevant time, the Mutual Assistance Directive for the Recovery of Claims (76/308/EEC) did not apply to direct taxes. However, in 1952, Belgium and Luxembourg concluded an Agreement on Mutual Assistance in the Recovery of Tax Claims which may also have a bearing on this case.

Nevertheless, the AG states that the collection of the tax on interest derived by non-residents under normal assessment procedures (as is the case for Belgian resident lenders) would result in significantly higher costs, both for the tax authorities and the group concerned. Therefore, such an assessment procedure would not provide a satisfactory alternative.

The AG also points out that a cash flow disadvantage for Belgian companies paying interest to foreign companies, as put forward by the European Commission, is not apparent in the case at hand, as the corporate income tax levied on Belgian lenders has to be pre-paid during the accounting year.

Finally, the AG acknowledges that the consolidated tax burden on non-resident lenders is indeed higher when taking into account the Luxembourg corporate income tax, as there is no foreign tax credit available, based on the Belgium-Luxembourg double taxation treaty. However, the AG takes the position that the Luxembourg corporate income tax should

**Direct tax country updates:
Belgium (continued), Denmark,
Estonia**

not be taken into account when making the comparison with a purely domestic situation. The EU freedoms cannot prevent the double taxation that arises from the parallel exercise of tax powers by Member States.

The AG also distinguishes the case from earlier court cases where the EU compliance of dividend withholding taxes was at stake. In the cases of *Denkavit* (C-170/05) and *Amurta* (C-379/05), the ECJ ruled that Member States providing relief from economic double taxation to residents should apply the same relief to non-residents. As regards relief from economic double taxation, residents and non-residents receiving dividends are to be considered comparable categories.

The interest withholding tax exemption, however, does not aim to provide relief from double taxation. Although resident lenders benefit from a withholding tax exemption, the interest is still subject to the corporate income tax through the normal assessment procedure. Obviously, the tax charge imposed on non-resident lenders is not higher when taking into account the Belgian corporate income tax rates (in this case, between 28 and 39%).

For corporate income tax purposes, a resident lender can take into account professional expenses when computing the tax due. Conversely, the withholding tax on interest paid to non-residents does not take into account these expenses. The AG, however, reasons that this difference results from the Belgium-Luxembourg double tax treaty, in which Luxembourg and Belgium agreed that the taxation power over interest paid to Luxembourg lenders is allocated to Luxembourg, except for the 15% Belgian withholding tax.

Conclusion

If the position of the AG is confirmed by the ECJ, double taxation caused by the Belgian interest withholding tax imposed on EU non-resident lenders will remain. It should be noted, however, that since the assessment years at stake in this case, numerous exemptions of Belgian interest withholding tax have been introduced or broadened by both domestic tax law (e.g., Belgian financing companies) and the Interest and Royalties Directive. In addition, Belgium has a wide treaty network based on which withholding tax exemption may be available. These measures should mitigate significantly any double taxation with respect to Belgian inbound financing.

Denmark

Taxation of foreign real property

The Danish Minister for Taxation has introduced a bill which will amend the legislative provisions governing the taxation of real property located outside of Denmark. The bill must be seen in the light of the ECJ ruling in the *Jäger* case (C-256/06).

Under current rules, property value tax is levied on properties located outside of Denmark based on the market value at 1 January 2001 or at the date of acquisition, if this date is later. In general, however, properties in Denmark are taxed according to the public land assessment at 2001 or 2002. All things being equal, this will result in property situated abroad being taxed more highly than a property in Denmark.

Consequently, it is proposed that the calculation of property value tax on foreign property is to be based on a foreign land assessment, if any, which is comparable with the Danish land assessment. If no comparable valuation is available, the acquisition price will be indexed at the 2001/2002 level and adjustments will be made for the difference which existed at that time between the Danish land assessments and the actual market values. In this way, a foreign property will be taxed in the same way as a Danish property.

The bill also implies a change to the provision for relief for foreign taxes as far as the Danish property value tax is concerned. According to the rules in force, credit relief is granted for foreign tax which "according to its nature" corresponds to the property value tax. This has given rise to difficulties, for example in relation to the new Swedish *fastighetsavgift*, which "according to its nature" does not correspond to the Danish property value tax. The provisions are to be amended so that credit relief may also be granted in respect of the new Swedish tax.

The legislative provisions will come into force on 1 January 2009 and so be effective for the 2009 income year. However, the provision for credit relief in respect of foreign tax must be effective as of 2008.

Estonia

Pensions paid to non-residents

On 16 October 2008, the European Commission formally requested Estonia to amend its discriminative taxation of pensions paid to non-residents. The request took the form of a "reasoned opinion" (the

Direct tax country updates: Estonia (continued), Germany

second step of the infringement procedure provided for in Article 226 of the EC Treaty). 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 Commission's case reference numbers are 2006/4221 and 2008/4640.

Currently there are various draft laws under discussion in the Estonian Parliament, which concern several amendments planned in the Income Tax Act. However, as far as we know, there is no draft legislation dealing with the exemption of pension payments to non-residents.

The Commission's reasoned opinion concerns non-resident pensioners and taxation of the pension paid. Annual tax exemption allowances applicable to pensioners in Estonia are EEK 63,000 (approximately € 4,026). The tax exemption allowance comprises a basic exemption of EEK 27,000 (about € 1,726) plus the exemption of pension payment up to a maximum of EEK 36,000 (about € 2,300). When non-resident taxpayers receive all their income in Estonia, they can benefit from the Estonian personal allowances. However, when the income earned in Estonia does not exceed 75% of their worldwide taxable income, non-resident taxpayers are not entitled to the deductions available to residents.

Under EU taxation principles, there should be no discrimination against non-residents. In this particular case, non-residents are in an inferior position compared to the residents, which could be regarded as indirect discrimination. The Commission considers that the Estonian legislation constitutes a discriminative clause that is prohibited by Article 39 of the EC Treaty. Article 39 guarantees freedom of movement for employees and the abolition of any discrimination based on nationality between employees of the Member States, with regard to employment, remuneration and other conditions of work.

In order to avoid discrimination, Estonia has already given tax deductions to non-residents. On 1 May 2004, amendments to the Income Tax Act were made in accordance with the Commission's recommendation (94/79/EC), which stated that it does not seem justified to require the Member State of activity (i.e., the Member State where the non-resident works) to grant non-residents the deductions if the non-resident derives a large share of income in his country of residence. The 75% threshold also offers

the advantage that the Member State of activity might abstain from taking into account the income obtained outside that State (in applying progressivity), and the task of the tax administration would thus be made considerably easier. To the best of our knowledge, Estonia will remain in the position that the 75% threshold is reasonable.

Quite apart from the Commission's request concerning the taxation of pensions paid to non-residents, interpretation of European legislation is an ongoing process. As a result, the Commission's request might have consequences that go beyond changes to Estonian domestic tax law.

Previously, on 31 January 2008, Estonia received a formal notice from the European Commission concerning a potential conflict in the rules, according to which dividends paid to foreign pension funds may be taxed, while dividends (and interest) paid to domestic pension funds are tax exempt.

Germany

ECJ judgment in KRW case

On 23 October 2008, the ECJ issued a decision in the case of *Krankenheim Ruhesitz am Wannsee - Seniorenheimstatt GmbH (KRW)*. This case (C-157/07) concerned the recapture in Germany of losses generated by the Austrian permanent establishment (PE) of a Germany resident company. The ECJ ruled that the freedom of establishment does not preclude a national tax system that, after having allowed the consideration of losses incurred by a foreign PE for the calculation of the headquarters' income tax rate, provides for the tax reintegration of those losses to the extent the tax treaty in place provides for the exemption method with regard to the profits generated by the PE.

Background

During the years 1982 to 1990, KRW's Austrian PE generated losses which, according to German income tax law in conjunction with the corresponding Germany-Austria double tax treaty, were offset against the respective earnings of the headquarter in Germany. From 1991 to 1994, the PE generated profits. The tax treaty allocates the right to tax the income of the PE exclusively to Austria. The German tax system provides that losses made by a PE are to be taken into account in the results of the company established in Germany, but it also provides for the reintegration of the losses of the foreign PE into the basis of assessment of the principal

Direct tax country updates: Germany (continued)

company when the PE makes profits and has the possibility of using the losses in the future. The German law does not provide for this reintegration in the case of PEs in Germany.

ECJ judgment

The ECJ had to consider whether the different treatment of losses generated by domestic and foreign PEs constitutes a restriction on the freedom of establishment (Article 52 EC). National provisions that establish the reintegration of the losses generated by a foreign PE provide for a less favourable treatment than that enjoyed by resident companies with PEs situated in Germany, even when the reintegration only takes place up to the amount of the profits made by that foreign PE.

The ECJ considered that the reintegration of the losses provided for in the main proceedings constitutes the logical complement of the deduction previously granted, as, according to the tax treaty, Germany did not have the right to tax the Austrian source income.

Therefore, in the view of the ECJ, the restriction provided for in the German tax system is justified by the need to guarantee the coherence of the German tax system. Besides, it is appropriate and proportionate to achieve such an objective, as only the losses previously deducted are being reintegrated, and the reintegration only takes place up to the amount of the profits made.

With respect to the impossibility of the taxpayer being able to benefit from the deduction of losses under Austrian law, due to the specific circumstances of the PE, while this possibility was available, in general, to any Austrian taxpayer, the ECJ ruled that the freedom of establishment cannot be understood as meaning that a Member State is required to draw up its rules on the basis of those in another Member State, in order to ensure taxation which removes any disparities arising from national tax rules, given that the decisions made by a company as to the establishment of commercial structures abroad may be to the company's advantage or not, according to the circumstances.

Implications

The decision in the KRW case shows that national regulations that provide for the reintegration of losses generated by a foreign permanent establishment are compatible with the freedom of establishment to the extent the losses have been taken into consideration in

the headquarter's taxable base, although the income of the PE is tax exempt in the headquarter's state of residence, and the reintegration only takes place up to the amount of the PE's profits.

The system applied by Germany with loss consideration and subsequent recapture is a perfect example of fiscal coherence.

Donations to non-profit organisations

On 14 October 2008, AG Paolo Mengozzi announced his opinion in the *Persche* case (C-318/07). The case concerns the German tax treatment of donations to non-profit organisations. The treatment distinguishes between donations to German organisations and donations to organisations situated in another Member State. The AG holds that these differences are a breach of the principle of the free movement of capital.

Background

The *Persche* case concerns the deduction of donations to non-profit organisations from the basis of German income tax. Mister Hein Persche, a German citizen, has made several donations in kind to an organisation which is situated in Portugal and, in terms of Portuguese law, considered as a non-profit organisation. The German tax authorities denied the deduction, because the recipient of the donated goods is a non-resident organisation and because the donation receipt provided by Mr. Persche did not meet the formal requirements of the German Fiscal Code.

AG's opinion

AG Mengozzi classifies the donation of convenience goods as a movement of capital in terms of Article 56 of the EC Treaty. Therefore, he regards the flat denial of the deduction of the donations as a disproportional breach of the principle of the free movement of capital. In his eyes, a German citizen shall have the right to provide sufficient evidence that the foreign organisation meets the German national requirements on non-profit organisations. Furthermore, the AG considers the denial of the deduction as unacceptable unless the German tax authorities do not obtain administrative assistance from the tax authorities of the other Member State, with regard to the non-profit character of the foreign organisation.

Implications

The classification of the donation of convenience goods as movement of capital in terms of Article 56 EC is astonishing to say the least. However, the opinion is in line with settled case law. Nonetheless it

Direct tax country updates: Germany (continued), Italy, Lithuania

requires lots of documentation from both sides and therefore causes an enormous increase of bureaucracy. In fact, the opinion of the AG requires the fiscal authorities of a Member State to prove any evidence delivered by the taxpayer concerning the non-profit character of an organisation which is situated in another Member State and which is receiving cross-border donations. This will surely result in a tremendous number of definition problems.

Italy

Modification of abuse of law principle

In a recent decision (n. 25374 of 17 October 2008), the Italian Supreme Court partially modified its interpretation concerning the abuse of law principle.

The latest decision is a follow-up of the *Part Service* case reported in the last issue of *EU tax news* and decided upon by the ECJ on 21 February 2008 (C-425/06). The case was focused on a VAT case but, again, the Italian Supreme Court took the opportunity to state that the abuse of law principle must be seen as a general anti-avoidance provision immanent in the Italian tax system, regardless of whether the circumstances involve VAT or direct taxes. Note also the decision of the Italian Supreme Court n. 21170 of 6 August 2008.

Nevertheless, after having reaffirmed the general principle mentioned above, the Italian Supreme Court underlined two new elements.

Firstly, the abuse of law principle has to be used by Italian tax authorities very carefully because it cannot limit the fundamental (economic) freedoms provided by the Italian Constitution or by the EC Treaty. This indication seems to recall the position of the AG Poaires Maduro, according to which the European "Court continues to use the notion of abuse with considerable restraint" (point 29 of his opinion in the *Cartesio* case [C-210/06]). Actually, continued AG Maduro, "the abuse of rights principle" has been described as "a drug which at first appears to be innocuous, but may be followed by very disagreeable after effects" (footnote 55 in his opinion in the *Cartesio* case). This argument is quite important because, after the first decisions of the Italian Supreme Court, the Italian tax authorities showed a tendency to apply the notion of abuse of law quite widely.

Secondly, the Italian Supreme Court stressed (thus changing its previous position) that it is up to the Italian tax

authorities to prove the existence of a number of objective factors showing that the essential aim of the transactions concerned is to obtain a tax advantage.

Only if this evidence is achieved, the taxpayer has to prove, in his turn, that the transaction was put in place for effective business reasons.

In the decision at hand, the Italian Supreme Court therefore provided some elements in order to avoid the "abuse" of the abuse of law principle.

Lithuania

Loss carry forward

According to the recent amendments of the Law on Corporate Income Tax, losses may be carried forward for an unlimited period of time, unless the entity ceases the activities which gave rise to the losses. Losses incurred from disposal of securities and/or derivative financial instruments may be carried forward for no longer than five years and may only be set off against gains of the same nature.

Research and development expenses

The amendments to the Law on Corporate Income Tax also introduced the concept of scientific research and experimental development costs (R&D expenses). According to the provisions of the law, R&D expenses (except depreciation and amortisation) may be deducted three times in Lithuania if the following is satisfied:

- ▶ The R&D was carried out in the European Economic Area (EEA); or
- ▶ The R&D was carried out in a tax treaty country.

For depreciation and amortisation of fixed assets used in R&D, stepped up rates are applied.

The above mentioned provisions are applicable for calculating taxable profit for the tax periods beginning in 2008.

Investment projects

A new draft amendment to the Law on Corporate Income Tax introducing favourable taxation of investment projects has been presented to the Lithuanian parliament, but has not yet been adopted.

According to the draft, taxable profit may be reduced by 35% with the expenses related to an investment project (that which is related to the acquisition and installation of new technological lines as well as the modernisation of existing ones). If the expenses to purchase the investment assets

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

exceed 35% of the taxable profit, the part of expenses exceeding 35% can be carried forward to the next four tax periods.

Investment assets have to be:

- ▶ Attributable to specific fixed asset groups listed in the Lithuanian Law on Corporate Income Tax.
- ▶ The assets must be new or produced no longer than two years ago. Fixed assets which resulted in the reduction of the taxable profit as per above, should be retained in business use by the taxpayer for not less than three years.

If adopted by parliament, the exemption would be applied for the taxable periods of 2009 - 2013.

Netherlands

Deduction of interest by non-resident

On 16 October 2008, the ECJ issued its ruling 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. However, under the Belgium-Netherlands tax treaty, he qualified as a resident of Belgium and the tax treaty 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.

The answer of the ECJ 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 is eventually not entitled to such a deduction, constitutes a forbidden discrimination. According to the ECJ, the interest expenses relate to the public servant's ability to pay tax. Since the taxpayer derives most of his taxable income in the Netherlands and has no significant income in Belgium, the Netherlands is obliged to take into account the financing costs relating to the Belgian real estate.

Bosal case and free movement of capital

On 26 September 2008, the Dutch Supreme Court decided on the compatibility

with the free movement of capital of the Dutch denial of deduction of so-called *Bosal* costs, including foreign exchange losses, relating to subsidiaries established in the Czech Republic (which was not a Member State of the EU at the relevant time).

The first question is whether Article 56 EC is applicable in the case of shareholdings which give holders a substantial influence over the companies' decisions and activities. The Supreme Court decided that these cases only fall under the ambit of Article 43. Accordingly, Article 56 EC cannot be invoked to the extent that majority shareholdings are involved.

Regarding the non-deductibility of the remaining *Bosal* costs, the Dutch Supreme Court established that this restriction is safeguarded by the standstill clause of Article 57(1) EC, as a result of which no conflict with the free movement of capital is present. The court then elaborated on the compatibility of the denial of these costs with the free movement of capital, as laid down in the former EU Association Agreement with the Czech Republic.

The Dutch Supreme Court decided that there is no conflict since the restriction at hand does not relate to any transaction on the capital account of the balance of payments, as required under this Agreement. With respect to the non-deductibility of currency losses, the Dutch Supreme Court established that this particular restriction was introduced in 1997 and, therefore, does not fall under the standstill clause of Article 57(1) EC.

Most-favoured nation (MNF) doctrine and the granting of tax-sparing credits

On 10 October 2008, the Dutch Supreme Court gave its ruling in a case regarding the application of the MNF doctrine with respect to the tax-sparing credit provisions in the tax treaties with Greece and Brazil. The case concerns a Dutch multinational which has investments all over the world. It receives dividends, interest and royalties from a number of its foreign subsidiaries, such payments being taxed with local withholding tax. The question was whether the Dutch company should be granted a tax-sparing credit based on the MFN doctrine.

This question was answered by the Dutch Supreme Court in the negative. Although the court recognised that there is a differential treatment between investments in Greece and Brazil and investments in the other states (both EU Member States and third countries), it considered, with reference to the *D* case (C-376/03),

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

that this differential treatment does not constitute arbitrary discrimination, since there is no comparability between both categories and different tax treaties apply to them. According to the Dutch Supreme Court, the tax-sparing provisions constitute an integral part of the tax treaties concerned and cannot be separated from the rest of the tax treaty. As a result, the taxpayer's claim was rejected.

Spain

Infringement procedures

The European Commission has formally requested Spain to amend certain tax provisions. These requests take the form of reasoned opinions. If there is no satisfactory reaction from Spain to the reasoned opinions within two months, the Commission may decide to refer the matters to the ECJ. The Commission references are 2007/4129 and 2007/2373.

In particular, the Commission has requested Spain to amend the following tax rules:

(1) The tax rules covering non-resident taxpayers operating in Spain without a permanent establishment.

Non-residents are taxed on the gross amount of their income, while residents are taxed on their net income. The Commission considers, on the basis of the ECJ judgments in the cases of *Asscher* (C-107/94), *Scorpio* (C-290/04) and *Gerritse* (C-234/01) that these Spanish tax rules restrict the free movement of persons and workers, the freedom to provide services and the free movement of capital.

The Commission request may affect, for instance, the treatment of business income obtained in Spain without a permanent establishment by residents of EU jurisdictions which have not signed a tax treaty with Spain (for instance, Gibraltar or Cyprus), as they may only deduct certain short-listed costs from their gross revenues, in order to determine their taxable income (basically, costs related to personnel and supplies directly related to the work carried out in Spain). By contrast, resident taxpayers may deduct all the business costs in order to arrive at their taxable base. The request may also affect the tax treatment of royalties and other passive income earned by non-residents in Spain (for instance, rental income or interest), which is taxed on a gross basis.

(2) The tax rules for determining the taxable base of non-resident taxpayers for capital gains purposes.

In principle, the taxable base of capital gains earned in Spain by non-resident taxpayers is determined in accordance with the rules applicable to resident taxpayers, except in particular cases (i.e., the dissolution of partnerships and joint ownerships, or of a marriage community property, and the transfer of funds between two collective investment schemes under certain conditions) where, for the Spanish resident, there is no taxable transaction. These exceptions do not apply to non-resident taxpayers. The Commission deems that this gives rise to discriminatory taxation against EU taxpayers because, for example, a taxpayer resident in Spain would not be taxed on the gain arising upon dissolution of a partnership, while a non-resident would be taxed on that gain.

(3) Exit tax provisions for individuals

Under Spanish tax law, a taxpayer who transfers his/her residence abroad has to include any deferred income in his or her tax declaration for the last tax year in which he or she is still considered a Spanish taxpayer, which means that the taxpayer will be immediately taxed on such income. The Commission considers that this immediate taxation of deferred income is contrary to the right of free movement of individuals, as interpreted by the ECJ in its judgment in the *De Lasteyrie* case (C-9/02).

United Kingdom

Controlled foreign companies rules

The UK High Court recently gave its judgment in the case of *Vodafone 2 v Commissioners for HM Revenue & Customs*, which concerns the compatibility of the UK's controlled foreign company (CFC) rules with European law.

This follows on from the decision of the ECJ in *Cadbury Schweppes* (C-196/04), which also considered the validity of the UK's CFC rules. The ECJ found that CFC rules in EU or EEA countries can only be justified where they specifically apply in respect of a CFC established in another EU/EEA country that is part of "wholly artificial arrangements". The meaning of "wholly artificial arrangements" is yet to be determined, but, based on previous case law, a "wholly artificial arrangement" may exist where the CFC is not actually pursuing "genuine economic activities" through a fixed establishment.

In broad terms, the *Vodafone 2* case is now considering whether the UK's CFC rules, as currently drafted, can be interpreted

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

in such a way that they comply with the ECJ's finding as to when the CFC rules may operate - as the UK government argued - or whether they must be disregarded until the UK Government has enacted new CFC rules that do comply with the ECJ's judgment in *Cadbury Schweppes* - as the taxpayer contended.

The High Court judgment found in favour of the taxpayer, on the basis that it would be going too far for the courts to "amend" the existing UK legislation and that it is for parliament to introduce appropriate legislation. Therefore, the UK CFC legislation should be disapplied, pending such amendment.

It is highly likely that the High Court's decision will be appealed to the Court of Appeal. If the Court of Appeal hears such an appeal, it may well be that any decision rendered by that court is then appealed to the House of Lords, which is the UK's court of final appeal.

This case is potentially relevant to all groups with European subgroups, which include a UK parent company. Such UK companies may potentially have been subject to a "CFC apportionment" (i.e., taxable charge) under the UK's CFC rules. Where that tax charge has arisen in respect of CFCs located in EU/EEA countries, this decision suggests that such tax charges may have been unlawfully imposed.

Late paid interest deductibility

The UK Revenue Authorities have recently issued various publications dealing with the potential incompatibility of the "late paid interest rules" with European law. Broadly, a UK company that has borrowed funds from another UK company obtains a tax deduction for interest on an accruals basis, regardless of whether the interest is paid or unpaid. However, where a UK company has borrowed funds from a connected EU/EEA company (or any non-UK company), under the "late paid interest" rules, a tax deduction for interest will broadly only be available once the interest has actually been paid (i.e., deductibility is deferred until the date of payment).

The rules therefore provide a UK company that has borrowed from a connected party with a different tax outcome, depending on whether the lender is a UK resident or not. It has been alleged that this difference in treatment contravenes European law, in circumstances where the lender is an EU/EEA company (though no court case has yet confirmed this point).

Given the potential incompatibility of the

"late paid interest" rules with European law, HMRC has announced that they will no longer enforce the "late paid interest" rules in their current form. Interestingly, although the alleged contravention of European law should only be relevant where the lender is an EU/EEA company, HMRC has stated that they will not enforce these rules, even in circumstances where the lender is a non-EU/EEA company.

One of the documents released is a "consultation document", in which HMRC has requested comments from taxpayers as to how the rules governing the timing of interest deductions should be framed going forward. This consultation process will continue and, following this process, revised legislation is likely to be published in due course, possibly in 2009. In the meantime, UK borrowers affected by the "late paid interest" rules should have a choice between applying the rules in their current form and thereby deferring a deduction until the interest has been paid, or taking advantage of the concession that has been announced and claiming a deduction on an accruals basis.

Indirect tax

Country updates: Cyprus, Denmark

Cyprus

Reverse charge services

On 6 November 2008, the ECJ issued its judgment in the *TRR* case (C-291/07), concerning the reverse charge services received by a mixed company on place of supply (in particular the position where reverse chargeable services are provided by a supplier in one Member State to a customer in another Member State, who is registered for VAT but is using the services wholly for a non-business purpose).

According to current Cypriot law and the respective approach taken by the competent authorities in Cyprus, a company should apply VAT on reverse charge services only if the company received them from abroad for the purposes of any business (i.e., economic activities) carried on by it. If a company is a mixed company (i.e., engaged also in non-economic activities) and it receives reverse charge services directly attributable to these non-economic activities, it is not obliged to apply the reverse charge rules on these services.

Under the current rules, the competent authorities take the view that VAT should not be reverse-charged even when the supplier does not charge local VAT. This is provided the company can substantiate that the services relate to its non-business activities (such as 'pure' holding activities).

Following the judgment in the *TRR* case, the competent authorities in Cyprus are analysing the current law. They are expected to prepare amendments if their analysis shows that the existing law is not in line with the ECJ judgment.

Denmark

Deduction of input tax

On 23 October 2008, AG Sharpston delivered her opinion in the *Danfoss A/S and AstraZeneca A/S v Skatteministeriet* case (C-371/07).

The reference for a preliminary ruling from the *Vestre Landsret* (Western Regional Court), Denmark, concerned the VAT treatment of company canteen meals provided to business contacts and staff in the context of business meetings. The question was whether such provision, when free of charge, should be regarded

as an application for private use on which output VAT is chargeable if input VAT was deductible. Furthermore, it had to be evaluated whether Denmark could legitimately retain an exclusion of such transactions from the right to deduct input tax on the basis of a standstill clause in the EU legislation - against the background of a rather complex sequence of national administrative and legislative measures.

Background

The Danish court's questions were posed in the context of two cases involving, respectively, the companies Danfoss A/S (Danfoss) and AstraZeneca A/S (AstraZeneca).

Danfoss, which produces and markets industrial automation systems, has staff canteens at various branches. Those canteens are also used to provide meals free of charge to both business contacts and staff in the context of business meetings on company premises.

AstraZeneca distributes pharmaceutical products in Denmark. As part of its activities, it invites health professionals to information meetings concerning various pathologies and the positioning and use of products in relation to them. Depending on the duration of the meetings, participants (only business contacts) may be offered meals free of charge in the company's canteen, which is otherwise used for the sale of food and beverages to staff.

For Danfoss the case related to the period from 1 October 1996 to 30 September 2001, and for AstraZeneca to the period from 1 October 1994 to 31 December 1999.

Following a ruling by the national tax tribunal (*Landsskatteretten*) in 1999, both companies applied for a refund of the output VAT which had been assessed on the basis of the calculated cost price of the meals provided free of charge to business contacts and staff.

The tax authority refused to repay the sums claimed (DKK 5,920,848.19 for Danfoss and DKK 825,275.00 for AstraZeneca), on the ground that the provision of meals and refreshments to staff is "food" covered by the deduction exclusion in Paragraph 42(1)(1) of the Danish VAT legislation (*Momslov*), and the provision of meals to

**Indirect tax country updates:
Denmark (continued),
Netherlands**

business contacts is "hospitality" covered by Paragraph 42 (1) (5). However, since the companies had deducted in full the VAT on their canteen inputs in accordance with the administrative practice previously applied, VAT should be assessed on application for private use in accordance with Paragraph 5(2) of the *Momslov*.

The claim consequently went to the national tax tribunal, and the proceedings now before the western high court (*Vestre Landsret*) challenge decisions of that body, holding that, in addition to tea and coffee, other drinks and food served in meetings at the company constitute "hospitality" when served to business contacts and "food" when served to staff, and that it was therefore justifiable to calculate VAT on the basis of application for private purposes.

The companies submitted that the deduction exclusions for hospitality and food under the *Momslov* are contrary to the Sixth VAT Directive.

The tax authority, while accepting that the exclusions are not covered by the first subparagraph of Article 17(6) of the Sixth VAT Directive, maintains that they arose from the *Momslov* as applied before the entry into force of that directive, and can therefore be lawfully retained pursuant to the standstill clause in the second subparagraph of Article 17(6).

The companies disagree, on the ground that the exclusions were not applied to the provision of meals in question until the administrative practice described was overruled in 1999, before which there had been full VAT deduction in accordance with that practice. In any event, the companies also claimed, taxation as applications for private use under Paragraph 5(2) of the *Momslov* is contrary to Article 6(2) of the Sixth VAT Directive, since, under that provision, such taxation is only permissible if the application is for purposes unrelated to the company's business, which is not the case with the provision of the meals in question.

Conclusion

In giving her opinion, AG Sharpston pointed out that Articles 5(6) and/or 6(2) of the Sixth VAT Directive cover the supply of meals by a taxable business free of charge to business contacts in its own canteen when the meal serves principally purposes other than those of the business. However, such supplies are also capable of serving principally the purposes of the business, in particular if they are intended to enhance the efficiency of meetings in which the

recipients are participating, and in such cases are not covered by those provisions.

Those same provisions cover the supply of meals by a taxable business free of charge to an employee in its own canteen when the meal serves principally the employee's own private purposes. However, such supplies are also capable of serving principally the purposes of his employer's business, in particular if the employee is required by the constraints of the business to forgo any choice he would otherwise have enjoyed and to consume such a meal, and in such cases are not covered by those provisions.

However, supplies may not, in any event, be treated as effected for consideration under Articles 5(6) and/or 6(2) of the Sixth VAT Directive unless any VAT paid on goods or services forming part of the taxable amount, in the event of such treatment, is wholly or partly deductible.

Under the second subparagraph of Article 17(6) of the Sixth VAT Directive, a Member State may not retain an exclusion from deduction with respect to expenditure for which a right to deduct was recognised by administrative practice on the date when the directive came into force, even if the exclusion was provided for in theory under national legislation. Nor may a Member State, having once allowed deduction of VAT on certain expenditure after the directive came into force, subsequently revert to excluding the same expenditure from the right to deduct, even if such an exclusion had been provided for when the directive came into force.

Netherlands

VAT exemptions for activities carried out in the public interest

On 9 October 2008, AG Sharpston delivered her opinion in the case of *Stichting Centraal Begeleidingsorgaan voor de Intercollegiale Toetsing v Staatssecretaris van Financiën* (C-407/07).

Following a request for a preliminary ruling from the Dutch Supreme Court (*Hoge Raad*), the ECJ undertook to evaluate whether certain activities in the public interest, including hospital and medical care and closely related activities, are exempt from VAT. And, where persons, whose activities are exempt, form groups to provide their members with services that are directly necessary for the exercise of those activities, such services are also exempt if the groups merely claim from their members "exact reimbursement

**Country updates:
Netherlands (continued)**

of their share of the joint expenses" and if there is no likelihood of distortion of competition.

The question submitted was essentially whether the latter exemption extended to services provided to one or more members individually.

Background

Stichting Centraal Begeleidingsorgaan voor de Intercollegiale Toetsing (the Stichting) is a foundation whose members are various medical and sickness insurance bodies and, in some cases, the individual members of those bodies, such as individual hospitals. The activities of the Stichting's members are exempt from VAT. Its own overall aim is to promote quality in medical care.

To that end, it provides various services to its members. Most of those services (related in particular to defining and upholding professional standards for medical and nursing staff) are provided to hospitals, and the costs are apportioned among them according to the number of beds.

Such services (which are ultimately paid for by government funding) are agreed by the tax authorities to be exempt, pursuant to the national provisions implementing Article 13A(1)(f) of the Sixth VAT Directive.

The Stichting also provides other services to individual members on an occasional basis. Such services are invoiced individually to the member organisation concerned. According to the order for reference, it is not disputed that those services are directly necessary for the exercise of the members' exempt activities and that there is no question of distortion of competition. The tax authorities consider, however, that the criterion of "reimbursement of their share of the joint expenses" is not met.

Among other items, the distortion of competition was also examined in this case, but the Dutch government did not support the assumption that the contested services give rise to no distortion of competition. It pointed out, in particular, that national implementing provisions defining the scope of the exemption in Dutch law specifically exclude the provision of personnel, precisely on the basis that it is a service likely to cause serious distortion of competition.

The AG pointed out one further aspect. The national court's question refers to services "for which no more is invoiced than represents the costs incurred". That phrasing could cover services invoiced at less than cost price, in contrast to the exact

reimbursement specified in the Sixth VAT Directive. Clearly, any supply of services at less than cost price would have implications in terms of competition *vis-à-vis* commercial undertakings, which must be taken into account by the competent national court in its factual assessment.

AG's opinion

The Stichting and the European Commission submit that the question asked by the *Hoge Raad* should be answered to the effect that, provided that the other criteria in Article 13A(1)(f) are met, that provision covers services supplied by groups coming within its scope even if those services are supplied only to one or more members.

The Netherlands government considers that the provision cannot cover services provided and invoiced individually to members. At the hearing, it elaborated on its position, arguing that the crucial distinction is between services provided in the collective interest, which are covered, and those provided in a member's individual interest, which are not.

AG Sharpston agreed with the Stichting and the European Commission. If all the other conditions in Article 13A(1)(f) are satisfied; if the services are directly necessary for the exercise of an exempt or untaxed activity; if there is exact reimbursement of the expenses incurred; and if there is no likelihood of distortion of competition, then it seemed to the AG that an over-literal interpretation of the words "share" and "joint" would place an unwarranted and artificial restriction on the scope of the exemption.

The AG continued her opinion by noting that, in its written observations, the Netherlands government submitted that the purpose of the exemption is to avoid placing a VAT burden on services provided by a group for its members when the same services would have borne no such burden if they had been provided internally by each individual member. Such services are thus assimilated to internal transactions.

When a service is provided to a single member, the Netherlands government argues, it is comparable to a transaction on the open market, with the provider at arm's length from the recipient, and should not benefit from such treatment.

The AG mentioned that she remained unconvinced by the argument of the Netherlands government. Whether a particular service is provided by a group to one, several or all of its members does not change the relationship between

**Country updates:
Netherlands (continued),
United Kingdom**

provider and recipient or the nature of the arrangement. whereby resources are shared in order to achieve economies of scale.

At the hearing, the Netherlands government placed greater stress on the need for services, in order to qualify for exemption, to be provided in the collective interest of all the group's members rather than in the individual interest of specific members. It illustrated the distinction by referring to a school complaints board which provides all schools in the Netherlands with assistance in adjudicating on complaints. That service is provided in the collective interest of all schools, even if some schools do not require it in a given period, or even at all, and it should therefore be exempt under Article 13A(1)(f).

By contrast, if a school were to obtain legal advice, say on VAT matters, from the board's lawyers, that would be a service in the school's individual interest, and should not be exempt. While the AG would tend to agree with the result which the Netherlands government reached when analysing its example, the AG did not agree with the method it used.

In the circumstances described, the VAT advice would not qualify for exemption because it was not a service directly necessary to enable the school to exercise its exempt activity of providing education, and probably also because it is not one of the services for the purposes of which the board was set up. On the other hand, a service which did fall within the board's purposes and which was directly necessary for the exercise of the exempt activity of providing education should qualify for exemption regardless of the actual number of schools in receipt of it.

The AG believed, moreover, that the distinction between collective and individual interest is of no great relevance as an independent criterion. Unless members are obliged to benefit from every service offered by the group, they will choose to take advantage of those services which are of individual interest to them. And the availability of such services for all members will necessarily be in their collective interest - provided, as always, that the services are "supplied by independent groups of persons whose activities are exempt from or are not subject to value added tax, for the purpose of rendering their members the services directly necessary for the exercise of their activity".

The AG mentioned that since the *Hoge Raad* posed its question on the explicit

assumption that the only point at issue is whether the criterion of "reimbursement of their share of the joint expenses" is met, the AG would answer that question in the affirmative.

Conclusion

If the ECJ follows AG Sharpston's advice, it will rule that Article 13A(1)(f) of the Sixth VAT Directive covers services supplied to their members by groups coming within its scope, even if those services are supplied to only one or more members, provided that the remaining conditions laid down in the provision are satisfied.

United Kingdom

Supply of sports services

In the *Canterbury Hockey Club* case (C-253/07), the question arose whether services closely linked and essential to sport supplied by a non-profit-making organisation could be exempt from VAT. The ECJ judgment, issued on 16 October 2008, evaluated this question in relation also to the fact that the true beneficiaries of those services must be persons taking part in sport.

Background

Under the Sixth VAT Directive, certain services closely linked to sport, supplied by a non-profit-making organisation to persons taking part in sport, are to be exempt from VAT. Canterbury Hockey Club and Canterbury Ladies Hockey Club field several hockey teams. Their members pay annual subscriptions to the clubs, which are unincorporated associations. The clubs are themselves members of England Hockey, a non-profit-making organisation for the encouragement and development of the playing of hockey in England.

The Commissioners for HM Revenue and Customs, the UK tax authority, notified England Hockey that the affiliation fees it received should be subject to VAT. As the hockey clubs were not persons taking part in sport, those supplies of services did not fall within the exemption. The clubs appealed against that decision.

The UK High Court of Justice, before which the case was brought, asked the ECJ whether the term "persons", in the context of the exemption, includes corporate persons and unincorporated associations or whether it covers only natural persons.

The ECJ notes that the exemption does not apply only to certain types of sport but covers sport in general, which also includes sports necessarily practised by individuals in

**Indirect tax country updates:
United Kingdom (continued)**

groups of persons or in clubs. Sport within such a structure generally entails that, for practical, organisational or administrative reasons, the individual does not him or herself organise the services which are essential to participation in the sport, but that the club organises and offers these services, as, for example, the provision of a pitch or referee. Thus, if the exemption were to be interpreted as meaning that it requires that the services be supplied to natural persons taking part in sport in a sports club, the result would be that a large number of supplies of services would be automatically and inevitably excluded from the benefit of that exemption. Such a result would oppose the purpose of the exemption which is to extend the benefit of that exemption to services supplied to individuals taking part in sport. In addition, such an interpretation would not be consistent with the principle of fiscal neutrality inherent in the common system of VAT.

ECJ's decision

Accordingly, the ECJ ruled that, in order to ensure the effective application of the exemption, it must be interpreted as meaning that services supplied in connection with, among others, sports practised in groups of persons or in sports clubs are, generally, eligible to benefit from the exemption from VAT.

However, the ECJ noted that to be eligible for that exemption, the services must satisfy three conditions:

- 1 They must be supplied by a non-profit making organisation.
- 2 They must be closely linked and essential to sport.
- 3 The true beneficiaries of those services must be persons taking part in sport.

Supplies of services which do not meet those criteria, particularly those linked to sports clubs and to their operation such as, for example, advice about marketing and obtaining sponsors, cannot be exempted.

Finally, the ECJ pointed out that the services are not eligible for the exemption if their basic purpose is to obtain additional income for the organisation by carrying out transactions in direct competition with commercial enterprises liable for VAT. The UK High Court of Justice would need to determine whether the services supplied by England Hockey to the hockey clubs satisfy those conditions.

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