UPDATE ON LATEST ECJ TAX RULINGS AND THEIR IMPLICATIONS FOR US INVESTORS IN THE EU

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Background: EC Treaty

• Income taxes fall within the exclusive jurisdiction of Member States.

• Member States must exercise income tax jurisdiction consistently with EC Treaty’s fundamental freedoms.

• Fundamental freedoms prohibit discrimination (of foreign income or foreign persons) and restrictions to the proper functioning of EU single market.
Background: ECJ

• Judicial branch of the EU government.

• It interprets EU law and rules on compatibility of domestic tax laws with EU tax laws and EC Treaty’s fundamental freedoms.

• Cases are referred to ECJ by Member States’ national courts.

• ECJ’s rulings are EU Law, binding in all Member States, and create enforceable rights upon EU citizens and legal entities.
ECJ enforces fundamental freedoms and removes restrictions to the single market from domestic tax systems. It is not responsible for the soundness of the remaining structure.


Until 1995: general attitude of Member States: domestic tax system is EU-proof.

Recent years: survival of the international aspects of national tax systems is at stake.
Denkavit (C-170/05)

Denkavit International BV (NL)

Denkavit France SARL (France)

Agro Finances SARL (France)

dividends

50%

99.9%

50%
Denkavit (C-170/05)

- Dividends paid by French subsidiaries to Dutch parent (in 1987-1989) for FRF 14,500,000.
- France imposed WHT on outbound dividends at a domestic rate of 25%, reduced to 5% under the Netherlands/France Tax Treaty (equal to FRF 725,000).
- Domestic dividends not subject to WHT and almost totally (95 per cent) exempt to parent.
Denkavit (C-170/05)

- Three questions to ECJ:
  - does the 5% WHT on dividends paid to a foreign parent, whereas no tax is imposed on dividends paid to a domestic parent, amount to a restriction of freedom of establishment;
  - is it relevant that under the tax treaty the foreign parent is granted a FTC for French WHT;
  - does it make any difference that the Dutch parent does not receive any credit because dividend is exempt under Dutch participation exemption rules.
Denkavit (C-170/05)

• ECJ’s reply to first question:
  - foreign and domestic parents are in a comparable situation and should receive equal tax treatment for dividends paid by French companies;
  - different tax treatment based on residency of parent company is discriminatory and amounts to a restriction of (parent’s) freedom of establishment;
  - need to prevent foreign parent from avoiding tax on dividends not a justification of restriction (domestic parents are also exempt from tax on dividends).
Denkavit (C-170/05)

- ECJ’s reply to second question:
  - tax treatment arising from NL-France tax treaty must be taken into account to provide interpretation of EC law and determine possible violation of EC treaty;
  - domestic tax law in combination with relevant tax treaty form the legal framework in which to consider compatibility of a national tax with EC law;
  - potential violation (at the level of domestic law) can be remedied by applicable tax treaty.
ECJ’s reply to third question:

- tax treaty provisions must, in actuality, eliminate discrimination arising from domestic tax law (actual effect of tax treaty on taxpayer’s situation must be considered in assessing violation of EC treaty);

- if, as a matter of fact, no credit for the WHT applies because dividends are exempt in foreign parent’s home country, discrimination is not eliminated;

- consequently, WHT is discriminatory and violates EC treaty.
• Comments:
  - the case was decided under the freedom of establishment clause (foreign parent owned controlling interests in French subsidiaries);
  - no need to refer to the freedom of movement of capital clause (which applies to portfolio holdings);
  - would freedom of capital apply to non-EU controlling shareholders?
Denkavit (C-170/05)

- Other cases:
  - in Amurta (pending ECJ case C-379/05 referred by NL) Dutch sub’s dividend to Portuguese parent subject to 10% Dutch WHT, but WHT fully creditable (with refund) in Portugal;
  - in Focus Bank (EFTA Court decision E-1/04 of 11/23/04), Norwegian sub’s dividends to foreign parent subject to 15% WHT in Norway. EFTA court held that WHT violated EEA treaty regardless of whether foreign parent was entitled to FTC in its state of residence.
ACT Group Litigation (C-374/04)

• Group litigation, four classes of claimants. Class IV comprises 28 groups with nonresident parents. Test claimants are Pirelli (Italy); Essilor (France); BMW and Sony (the Netherlands).

• Pirelli owns a minority shareholding (less than 10%) in UK sub, the other nonresident parents own 100% control of UK subs.

• Claims brought under both freedom of establishment and freedom of movement of capital.

ACT Group Litigation (C-374/04)

- Foreign shareholders’ entitlement to imputation tax credit under UK’s repealed Advance Corporation Tax regime (ACT).

- Domestic dividends: for corporate shareholders, exemption and ACT tax credit; for individual shareholders, imputation tax credit. One level of tax.

- Outbound dividends: no UK WHT tax and no tax credit under UK domestic law; UK WHT and credit granted under certain DTCs (e.g. NL), but in some cases credit denied under treaty’s LOB provisions.
• Claimants’ argument: unfavorable treatment of ultimate shareholders is restriction of non-UK parent’s freedom of establishment (par. 33 and par. 35).

• Two questions to the ECJ: (1) is denial of credit for outbound dividends a restriction of non-UK parent’s freedom of establishment; (2) is granting credit to residents of certain Member States pursuant to tax treaties, or denying it pursuant to treaty’s LOBs provisions, discriminatory.
ACT Group Litigation (C-374/04)

• ECJ’s answer to first question:
  - non-UK parents and UK parents are treated alike, i.e. no UK tax on dividends in both cases (par. 61);
  - granting credit to non-UK parent “would mean in point of fact that [UK] would be obliged to abandon its right to tax a profit generated through an economic activity undertaken on its territory” (par. 59);
  - shareholders’ residence state has duty to eliminate double taxation at shareholder level (par. 64).
ACT Group Litigation (C-374/04)

- ECJ’s answer to second question (MFN argument):
  - Member States are free to enter into bilateral tax treaties;
  - treaty credit is not a separate benefit but integral part of that treaty;
  - companies of countries with treaties that grant credits not in a comparable situation as companies with countries whose treaties do not grant credits.
FII Group Litigation (C-446/04)


- UK parents receiving dividends from foreign subsidiaries.

- Domestic dividends exempt from corporate tax and taxed only at shareholder level.

- Foreign dividends subject to tax, with FTC for foreign WTH for <10% shareholders, and for foreign WHT and tax on underlying profits for 10% shareholders.
FII Group Litigation (C-446/04)

- Surplus ACT when UK parent paid out dividends to its own shareholders.
- Between 1994 and 1999, FID regime. Surplus ACT refundable to the extent that dividend paid matched foreign dividend received. Refund due when company liable for mainstream corporate tax (normally 9 months after end of accounting period).
- Cash-flow disadvantage for UK parents of foreign subsidiaries.
**FII Group Litigation (C-446/04)**

- ECJ’s ruling:
  - exemption system for domestic dividend and imputation system for foreign dividends resulted in unfavorable tax treatment of foreign dividends in violation of EC Treaty;
  - restriction of freedom of establishment for 10% shareholdings and of free movement of capital for <10% shareholdings;
  - UK FID scheme violated EC Treaty due to cash flow disadvantage for UK parents of foreign subs.
Cadbury Schweppes (C-196/04)

- Referred by UK on 4/29/2004; AG opinion on 5/2/06, ECJ’s ruling issued on 9/12/2006.

- CS UK had two controlled finance subsidiaries in Ireland which paid 10% corporate tax under Ireland’s IFSC regime. Subsidiaries raised capital from outside and lent it to members of Cadbury’s worldwide group.

- Subsidiaries’ income was taxed currently to the UK parent under UK’s CFC rules.

- CS UK argued that current taxation of its finance subsidiaries’ income violated EC Treaty (freedom of establishment and free movement of capital).
Cadbury Schweppes (C-196/04)

• CS stipulated that finance subsidiaries were formed in Ireland solely in order to benefit from lower tax rate. Finance subsidiaries had no offices or employees.

• CS could not pass the ‘motive test’ that would have exempted it from current taxation.

• ‘Motive test’ asks whether transactions with CFCs reduced parent’s income in excess of a minimum amount and the main purpose or one of the main purposes for setting up the CFCs or engaging in such transactions was UK tax reduction.
Cadbury Schweppes (C-196/04)

- Initial question to ECJ: is establishing a subsidiary in a foreign jurisdiction solely for tax reduction purposes a valid exercise or an abuse of freedom of establishment.

- ECJ’s answer: the fact that a company has been established in a Member State solely for the purpose of benefiting from a more favorable tax treatment “does not in itself suffice to constitute an abuse of that freedom” (Centros and Inspire Art).

- Next issue: is UK’s current taxation of foreign subsidiary’s income a discriminatory violation of EC Treaty’s freedom of establishment.
Cadbury Schweppes (C-196/04)

- Freedom of establishment protected also from restrictions by origin Member State (residence country).

- Relevant comparison: UK subsidiary that does not combine with UK parent.

- If subsidiary incorporated in the UK (or in a Member State where is not subject to a lower level of taxation for UK CFC rules purpose), resident parent is not taxed on subsidiary’s income.

- UK CFC’s unfavorable tax treatment restricted freedom of establishment and violated EC treaty.
• Possible justification: prevention of tax avoidance.
• ECJ recognizes anti tax avoidance only in case of fact-specific, narrowly-tailored rules targeting specific abusive situations.
• Setting up subsidiary in a favorable tax jurisdiction does not create a presumption of tax avoidance.
• ECJ’ standard: anti avoidance provision may be justified only if it specifically relates to “wholly artificial arrangements” “not reflecting economic reality”.

Cadbury Schweppes (C-196/04)
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• ‘Wholly artificial arrangements’ means “fictitious establishment not carrying out any genuine economic activity” (based on objective factors).

• Subjective element (main purpose) is non sufficient to satisfy that standard.

• Case referred back to UK court to determine whether motive test of UK CFC rules is restricted to wholly artificial arrangements so defined.

• Does freedom of movement of capital apply (in case of CFCs not in EU)?
Italian CFC Rules

- They apply to controlled companies organized in black listed jurisdictions.
- Black list includes EU member states (Cyprus and Malta).
- Exception: CFC actually carries out an economic activity in as its main trade or business in the country in which it is organized (with offices, people, etc. as needed).
- Italy’s tax administration’s position: rules are EU proof.
Thin-cap Group (C-196/04)

- Pending case (C-524/04) referred by UK. AG’s opinion issued on 6/29/2006.
- Are UK thin-cap rules (as applied before April 1, 2004) compatible with EC treaty (freedom of establishment)?
- Until 2004, rules applicable only to intra-group outbound interest; after 2004, applicable across the board.
- Until 1995 applicable to all interest (unless otherwise provided for under treaty). After 1995, only to interest exceeding arm’s length amount. Between 1998-2004, dealt with via UK general transfer pricing rules.
Thin-cap Group (C-196/04)

• AG’s opinion:
  • discriminatory restriction on freedom of establishment (unless cured by treaty), because rules provided unfavorable treatment for outbound interest;
  • restriction justified as proportionate response to tax abuse (after 1995 and 1998 changes in law);
  • extension of rules to domestic loans irrelevant (“pointless and counter-productive”).
**Thin-cap Group (C-196/04)**

- Restriction justified (proportionate) provided that:
  - taxpayer is permitted to demonstrate without undue burden that the transaction (even though not at arm’s length) was carried out for “genuine commercial reasons other than to gain a tax advantage”;
  - UK ensures (by treaty) reciprocal recognition by the state of residence of parent (lender) of UK re-qualification of interest ad dividends (no double taxation).
Italian Thin-cap Rules

- They apply across the board and deny deduction of interest on loans made or guaranteed by qualified shareholders or their related parties based on objective factors (debt to equity ratios).

- Interest re-characterized as nondeductible dividends only in case of granted loans. Re-characterization is generally neutral at domestic level.

- No “genuine commercial reasons” exception and no “reciprocal re-characterization relief” for cross border loans. No re-characterization for guaranteed loans.
CLT-UFA (C-253/03)

• ECJ’s ruling issued on 2/23/2006. PE discrimination case.

• Luxembourg company with branch in Germany. Germany taxed branch at higher corporate tax rate than domestic (German) companies.

• Violation of EC Treaty (Royal Bank of Scotland).

• Unfavorable tax treatment of branches almost always discrimination.

• Italian branches of foreign companies are treated in the same way as Italian companies.
Italian Branch Rules

- USP
- Branch
- IT1
- IT2
- IT3
Keller Holdings (C-471/04)

- German company with wholly-owned Austrian subsidiary.
- German law denied deduction for financing and administrative costs for acquisition of stock in Austrian subsidiary (costs to acquire domestic sub were deductible).
- Violation of EC Treaty (*Bosal*).
- Coherence argument rejected. No discrimination in deduction of cross-border losses (costs).
Italian Group Relief Rules

- Discrimination of Italy’ worldwide (vs. domestic) tax consolidation rules:
  - eligibility: only ultimate parent (vs. intermediate holdings);
  - minimum period: five years (vs. three years);
  - control requirement: >50% of stock (by value), vote and profits (vs. dominant influence even though below 50%);
  - scope of consolidation: pro rata share of foreign sub’s profits and losses (vs. all profits and losses);
Italian Group Relief Rules

- procedural requirements: audit of financial statements and mandatory advance ruling.

• Violation of EC Treaty?