European Tax Law*

I. Denmark

In 1990, Denmark will amend its intercompany dividend tax system to allow dividends received by a Danish company from a less than 25 percent owned affiliate to be freed from corporate level tax.[1]

The Danish Department of Tax has recently issued a ruling extending the dividend-received exemption regime to dividends paid by *foreign* subsidiaries of Danish companies. There are a number of exceptions to the extension, primarily based on the principle that income must have been subject to tax at the subsidiary level or, if the subsidiary in turn had received dividends from other subsidiaries, at the level of the latter.[2]

Such a ruling might render Denmark a more attractive location for a Scandinavian headquarters or coordination center, particularly if it is intended that such an entity also own shares of stock in other affiliates situated in the region. Norway and Sweden, for example, are specifically listed as generally qualifying jurisdictions for this purpose, although there is an exception for dividends paid by Swedish subsidiaries if such dividends are deductible by the distributor on newly issued shares.

II. France

The French Government has proposed (to be effective as of January 1, 1989) favorable tax rates for newly established French enterprises. During the first two years of operation, such businesses would be tax-exempt. A 75 percent reduction in tax will be available during the third year, 50 percent during the fourth year and 25 percent during the fifth year. These benefits will cover most commercial enterprises.

In addition, the corporate income tax rate on reinvested income will be reduced from 42 to 39 percent.[3] Finally, distributed earnings will be subject to the existing tax rate of 42 percent, which is somewhat analogous to the system that presently exists in Germany.[4]

III. Federal Republic of Germany

The United States and the Federal Republic of Germany initialled a new income tax treaty in January of this year. The new treaty, which it is hoped will

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1. *See* 18 Int'l Tax Plan. Man. (CCH) 4 (Mar. 29, 1989).
2. *See generally* Dik, *Denmark—Exemptions for Dividends from Foreign Subsidiaries; Qualifying Countries*, 29 EUR. TAX'N 155 (1989).
3. *See generally* 196 Doing Bus. Eur. (CCH) 4 (Nov. 15, 1989).
4. *See also id.* at 2.

be ratified this year, would replace the 1954 treaty and 1965 protocol thereto currently in effect.

Negotiations on a new treaty have been taking place for a decade. The United States was interested in obtaining additional relief from West German withholding taxes on dividends paid by West German companies to U.S. shareholders. Although the 1954 treaty limits such withholding taxes to 15 percent of the gross dividend amount in most cases, the introduction of a split-rate, partially integrated corporate tax system in 1977 substantially reduced the tax burden on dividends paid to West German shareholders without permitting nonresident shareholders a similar benefit.

In addition to accommodating U.S. concerns on this issue by reducing the dividend withholding rate in stages to five percent, the new treaty contains provisions designed to limit the availability of treaty advantages for certain tax-favored investments (e.g., West German investments in the U.S. REITs and mutual funds).

The West German *Bundesfinanzhof* (Supreme Tax Court) held in a decision issued in 1988 that the West German tax authorities did not act improperly in spontaneously notifying the French tax authorities that an individual operating a sole proprietorship in Paris had engaged in a transaction that might have resulted in income not being reported to the French authorities.[5] Although the French-West German income tax treaty may be read to preclude the delivery of such information absent a request therefore, the Court concluded that provisions of internal West German law permitting spontaneous disclosure to another European Community (EC) Member State are not rendered inoperative by the absence of such provisions in an otherwise applicable treaty.[6]

Thus, if the West German tax authorities receive information that gives them reason to believe that taxable income was not properly reported to another EC country, they may exercise their statutory discretion to disclose such information to that other country. Obviously, this decision has significant implications for multinationals with permanent establishments or affiliates in West Germany and one or more other EC Member States.

An interesting, recently published (July 27, 1988) decision of the German Federal Fiscal Court provides some potentially useful tax planning possibilities. In the case at issue, one Swiss company had transferred subscription rights to the share capital of its German subsidiary to another related Swiss corporation. The German tax administration sought to tax the transferor on a deemed capital gain on the grounds that there had been a sale of shares by a substantial investor. The Court, however, looked to form over substance and indicated that since no consideration had been paid for the transfer (presumably not even an issuance of new shares of stock in the Swiss transferee), no sale had occurred and hence no

5. Decision of Jan. 20, 1988, Bundesfinanzhof, 1988 BStBl.II 412.

6. *See* France-Federal Republic of Germany Income Tax Treaty of July 21, 1959, art. 22.

gain was available for taxation by Germany.[7] If this decision is followed by other courts, it might provide a method for tax-free international reorganizations of German groups. Of course, an issue remains as to how to dispose of the pre-existing share capital of the German company by the transferor; presumably it could be redeemed at some later point in time.

Yet again, the German Government has been planning to offer new proposals in order to develop controls on highly leveraged corporate groups. The latest draft provision to be added to the German Corporate Income Tax Act would have effectively established a 1:1 debt/equity ratio limitation on shareholder loans to German companies. The limit would only have applied to shareholders owning more than 25 percent of the German company and would apply primarily to foreign shareholders. Even if a company's debt/equity ratio does not exceed 1:1, the interest payments could be considered nondeductible to the payor if they include an "equity kicker" or are in some way based on the payor's profitability.

In view of the interest of many corporate groups in leveraging their German affiliates so as to reduce the effective German tax rate and avoid excess foreign tax credit limitation problems, this development should be carefully monitored.[8]

IV. Greece

The EC Commission recently extended from November 22, 1988, until December 31, 1989, the right of Greece to impose certain safeguard measures before removing all exchange controls. These interim measures apply to medium- and long-term capital flows into and out of Greece. Current restrictions on direct investments must be abolished as of July 1, 1989.[9]

Basically, Greece has not met its obligations under EC law with regard to the liberalization of capital movements. Nonetheless, there has been some movement in at least relaxing exchange controls, and the extensions have been getting shorter and shorter. Thus, there will inevitably come a time, perhaps by 1992, when Greek exchange controls will be entirely removed vis-à-vis other EC Member States.

V. Italy

A number of interesting provisions are included in a draft tax bill presently before the Italian Parliament, specifically:

(i) a "clawback" or recapture provision of losses that have been carried forward when profits are derived in future gains;

7. 1989 BStBl.II 271, *noted in* 240 World Tax Series Germany (CCH) ¶ 1401 (May 2, 1989).

8. *See generally* 16 Tax Plan. Int'l Rev. (BNA Int'l) 29–30 (May 1989); *see also* Borstall, *New German Thin Capitalization Rules?*, [May 1989] INTERTAX 185 (setting out an unofficial translation of the proposal).

9. *See* Eur. Rep. No. 1451, at II-1 (Nov. 26, 1988).

(ii) a provision whereby money that is paid out to shareholders as part of a merger transaction will be considered "boot" and therefore taxable income to the recipient;
(iii) a general prohibition against tax avoidance that will be inserted and defined in Italian tax law, albeit in general terms;
(iv) a limitation that only one-third of entertainment expenses will be deductible (this would appear to mirror recent reductions in the ability to deduct entertainment expenses in Belgium, France and the United States);
(v) leased assets will only be depreciable if the duration of the lease is no less than two-thirds of the depreciation period for the asset in question; and
(vi) loans made to persons other than a taxpayer's employees will generate taxable income no less than the average finance costs incurred by the taxpayer during the fiscal year in effecting the loan.[10]

Legislation has also been enacted in Italy that would provide for tax relief of up to 75 percent for corporate mergers amongst major companies. The remaining 25 percent of the capital gains subject to tax would be spread out over ten years, requiring annual tax payments. The 75 percent tax-free amount would only become taxable if the gains are ever realized due to a change in ownership or similar transaction.[11]

In Decree-Law No. 318 of September 11, 1989, the original provisions were amended so as to eliminate certain rules that made the new tax-free reorganizations seem too much of an illegal "state aid" under EC law.[12] Specifically, the original requirement that at least 50 billion Italian lire be contributed as new or increased capital of the transferee in the reorganization has been eliminated. This provision had raised complaints that only large-scale transactions could benefit from the regime. In addition, the deadline of December 31, 1990, has been removed. Finally, it would now appear more likely that nonresident companies may also benefit from the regime by contributing their Italian businesses or shares to another Italian company in exchange for shares. This latest version was rejected by the Italian Parliament for procedural reasons, so it must now be re-presented to Parliament as a formal bill.[13]

Note should also be made of the liberalization of capital transactions in Italy since October 1, 1988, pursuant to Law No. 445. Rather than requiring Central Bank approval, most Italian transborder transactions will now only require declarations for statistical purposes.[14]

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10. *See generally* Manzitti, *Italy to Enforce New Rules and Close Existing Loopholes*, INT'L TAX REP. 9–10 (Inst. Int'l Res. Oct. 1988).
11. Decree-Law No. 174 of May 15, 1989.
12. *See* 1 TAXES INT'L 406 (Oct. 1989).
13. 23 Tax News Serv. (IBFD) (Oct. 18, 1989).
14. *See* Doing Bus. in Eur. (CCH) No. 196, at 1 (Nov. 15, 1988).

VI. The Netherlands

The Dutch Supreme Court has recently decided that a parent Dutch corporation may file a consolidated tax return with its wholly owned subsidiary Dutch corporation even if the subsidiary is effectively managed in another country and, for purposes of any double taxation convention with that country, the subsidiary is a resident in that country.[15] The reasoning of the Court allows tax consolidation between a Dutch subsidiary and a Dutch incorporated parent that is effectively managed in a treaty country. Since no tax is required to be withheld on dividends paid within a consolidated group in The Netherlands, this structure may be used to avoid Dutch withholding tax on payments out of The Netherlands (i.e., dividends paid by the subsidiary). Dividends paid by the "dual resident" parent to its treaty country parent should also escape Dutch withholding tax, assuming the applicable treaty follows the pattern of the OECD Model Income Tax Treaty.

The Dutch Ministry of Finance is considering requests for relief from the one percent capital contribution duty in cases where a non-EC-based parent contributes shares of stock of a subsidiary to an intermediate Dutch holding company. If the parent is based in The Netherlands or in any other EC Member State, the tax is to be reduced under the "internal reorganization" provisions. The requests for relief are to be based on treaty nondiscrimination provisions, which generally prohibit discrimination on the basis of the foreign residence of the shareholders.

The Dutch Supreme Court has decided that a Singapore shipping company does not subject itself to tax in The Netherlands merely because it is represented in The Netherlands by a broker.[16] Because the broker in this case entered into agreements in the name of the foreign shipping company rather than in its own name, the tax authorities argued that the "independent agent" exception to the tax treaty permanent establishment definition did not apply. The Court rejected this argument, however, pointing out that both commission agents and brokers are in fact mentioned in the relevant treaty as examples of independent agents and that a broker typically acts under the name of its principal.[17]

The case is also of great significance to foreign insurance companies operating in The Netherlands through agents that they consider to be independent, but which may be considered dependent agents by the Government. Such insurers have for years been discussing their taxability with the tax authorities.

The new Dutch corporate income tax rates are 40 percent on the first Dfl 250.000 (approximately U.S. $120,000) of taxable income and 35 percent on the excess, effective as from October 1, 1988.[18]

15. Decision of June 29, 1988 (Hoge Raad), 1988 BNB 331.
16. Decision of June 15, 1988 (Hoge Raad), 1988 BNB 258.
17. Dutch Commercial Code (Wetboek van Koopenhandel) art. 62.
18. *See* Doing Bus. in Eur. (CCH) No. 195, at 5 (Oct. 12, 1988); 15 Tax Plan. Int'l Rev. (BNA Int'l) 30 (Oct. 1988).

A very interesting form of advice was recently rendered by the Dutch Under-Secretary of Finance involving the requirements for a participation exemption pursuant to article 13 of the Dutch Corporation Income Tax Act 1969. Traditionally, such exemptions have only been granted with regard to dividends paid from a foreign company when the latter has at least been "subject to" a profits tax. In the case at issue, a Dutch company owned 20 percent of the outstanding shares of stock of a Luxembourg holding company which, in turn, owned all of the stock of a Luxembourg operating entity. Even though the holding company is *not* subject to local income tax, the ruling indicates that a tracing or pass-through approach can be adopted so that the income will nonetheless be free from tax in The Netherlands.

The exemption is conditional upon several factors: (i) the holding company's only activity being the holding of the particular shares in question; (ii) the fact that the underlying operating company's profits are indeed subject to tax in the country of its residence; and (iii) ensuring that the holding company's sole source of income is the dividends flowing from the underlying operating company.[19] Perhaps this approach will now also be available with regard to the use of other erstwhile tax-free holding company jurisdictions such as the Channel Islands.

VII. Sweden

Sweden announced on November 23, 1988, that it plans to undertake a "sweeping" tax reform which would, inter alia, reduce corporate income tax rates from 58 to 30 percent. Commensurate with the developments in other countries, however, a variety of tax "loopholes" or breaks will be eliminated. Among the proposals is the imposition of capital gains taxes at the same rate as income tax.

VIII. The United Kingdom

A recent U.K. High Court of Justice (Chancery Division) decision in the case of *Union Texas Petroleum Corp. v. Critchley (HMIT),*[20] adopted an unexpected interpretation of article 10(2)(a)(i) of the U.S.-U.K. Income Tax Treaty of December 31, 1975. Although the Court held that the United Kingdom was indeed entitled to deduct a 5 percent withholding tax on the aggregate amount of dividends paid plus one-half of the Advance Corporation Tax (ACT) credit, the taxpayer won on an ancillary issue regarding how to calculate the withholding tax liability.[21]

19. *See* 15 Tax Plan. Int'l Rev. (BNA Int'l) 45 (Dec. 1988).

20. 1988 S.T.C. 691.

21. *See* 15 Int'l Tax Plan. Man. (CCH) 4 (Oct. 18, 1988); 15 Tax Plan. Int'l Rev. (BNA Int'l) 33 (Nov. 1988).