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European Tax Law

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REGIONAL DEVELOPMENTS

European Tax Law*

I. Austria

An interesting debate has recently emerged in Austria concerning the application of the "affiliation privilege" to dividends received by an Austrian permanent establishment of a foreign company.¹ The Austrian tax authorities have taken the position that the tax exemption provided for under its affiliation privilege regime is effective only in the case of dividends received by a resident Austrian parent company. Certain practitioners are challenging this position as a violation of the nondiscrimination clauses contained in most Austrian double taxation conventions based on the 1977 OECD Model Income Tax Treaty.

The debate is important because the outcome could substantially affect Austria's attractiveness as a situs for international holding companies. Under most of Austria's tax treaties, the taxation by Austria of a permanent establishment of a foreign company is limited to the establishment's Austrian-source income. If such a company were to own 25 percent or more of an Austrian or foreign company, then any dividends paid to it should be immune from Austrian taxation under the rules presently extant for the affiliation privilege. The Austrian tax authorities, however, argue that the affiliation privilege does not apply in such situations because the company itself is not an Austrian resident.²

*Prepared by the European Tax Law Subcommittee, Committee on International Taxation, Howard M. Liebman, Chairman (Oppenheimer, Wolff & Donnelly, Brussels, Belgium), with additional contributions from Marcel Romyn (Moret, Gudde, Brinkman, Marten, Rotterdam, the Netherlands), Samuel M. Löhman (Neuchatel and Geneva, Switzerland), and Kevin J. Moore (Salzburg, Austria).

1. See Lechner, *Holding Privilege and Nondiscrimination Clause*, 1990 STEUER UND WIRTSCHAFT INTERNATIONAL [SWI] 9; Loukota, *Tax Exemption for Investment Earnings of Foreign Corporations*, 1991 SWI 5.

2. *But see* Tax Letter Eur. No. 2/91, at 3 (Feb. 4, 1991) (discussing formal changes to Austrian tax law to allow the tax-free conversion of an Austrian corporation into an Austrian branch of a foreign corporation as long as the transaction otherwise meets the requirements of a tax-free reorganization).

Of course, the government's interpretation would subject foreign companies doing business in Austria in the form of a permanent establishment to more burdensome tax liabilities than their domestic counterparts, simply by reason of the fact that a tax treaty limits the ability of Austria to tax their income. Admittedly, if the converse view were to be accepted, a foreign company could effectively avoid any Austrian withholding taxes by establishing an Austrian permanent establishment, as the latter's profits would not be remitted back to the foreign company in the form of dividends. Given that Austria does not impose a branch tax, the dividends received by the permanent establishment would be immune from Austrian income tax under the affiliation privilege, and could then be remitted to the foreign head office without being subjected to Austrian dividend withholding tax.

The current debate will certainly be left for the courts or the tax authorities (competent authorities) of Austria's various treaty partners to decide. Interestingly, the European Court of Justice had decided in the context of certain tax issues arising within the European Community (EC) that a permanent establishment could not be discriminated against in analogous circumstances.³ How Austria will deal with this same issue remains to be seen.⁴

II. France

The French Finance Law 1991 reduced the corporate tax rate on undistributed income yet again, from 37 percent to 34 percent, for fiscal years beginning as from January 1, 1991.⁵ The rate on distributed profits remains at 42 percent. This split-rate system is the exact opposite of the German approach, which taxes distributed profits at a lower rate than undistributed profits (albeit subjecting distributed profits to a withholding tax as does France) as part of a policy of promoting such distributions. By contrast to the rate reduction for corporate income tax, certain long-term capital gains derived from the sale of financial assets such as bonds, bond warrants and holdings in SICAVs (a form of mutual fund) will now be subject to tax at 25 percent rather than 19 percent.⁶

In addition, the above-referenced legislation also amends the rules governing intercompany leveraging. Traditionally, a 1.5:1 debt-equity ratio is imposed on

3. Commission of the EEC v. France, Case No. 270/83, Judgment of 28 Jan. 1986, *reprinted in J. DR. FISCAL*, May-June 1986, at 177, *noted in 14 TAX PLAN. INT'L REV.* 34 (July 1987).

4. Portugal has also recently taken action to preclude the use of branches of foreign companies to receive dividends qualifying for the statutory 95 percent dividend-received exemption. Portuguese Law Decree No. 377/90 of Nov. 30, 1990, *amending* Portuguese Corporation Income Tax Code art. 45, No. 1, *noted in Tax Letter Eur.* No. 2/91, at 5 (Feb. 4, 1991). This action also would seem to contravene European Community (EC) law, at least insofar as it discriminates against branches of companies established in other EC Member States.

5. 2 TAX NOTES INT'L 1147 (1990); *see also* 25 Tax News Serv. (IBFD) 6 (Jan. 6, 1991).

6. 2 TAX NOTES INT'L 1250 (1990); *id.* at 1147.

tax-deductible borrowings by a French subsidiary from its foreign parent, but only when the parent maintains effective management and control over the subsidiary.⁷ Thus, loans from a direct or indirect shareholder that did not have effective managerial control over the borrower were, up until 1991, *not* subjected to this particular constraint.

The new provision would close this loophole and extend the nondeductibility of excess interest to interest paid to all so-called "associates," those being shareholders owning an interest or holding voting power of more than 50 percent in the borrower.⁸ Apparently, this new rule would not extend so far as to cover persons who are not shareholders. Hence, the technique of using a separate finance company that is a sister company, rather than a parent or a grandparent, of the borrower could still be acceptable.

III. Italy

A series of legislative measures has been generating controversy on the Italian tax scene. Particular mention might be made of the checkered background of a new capital gains tax in Italy. Pursuant to a Decree-Law of September 27, 1990, capital gains derived by individuals and noncommercial enterprises were subjected to tax at the rate of 20 percent (if the assets were held for less than eighteen months), with a 12.5 percent rate for long-term gains.⁹

At the time, the Italian Minister of Finance also considered proposing a limited tax exemption on income received from qualified participants (that is, a form of dividend-received deduction), presumably on top of the partial imputation credit system that already exists in Italy.¹⁰ The purpose of this latter measure was to promote investments in specific types of companies such as venture capital startups, small and medium-sized enterprises, and state organizations,¹¹ perhaps seeking to counter the disincentive created by the capital gains tax. In any event, the intention of the new capital gains tax legislation was to align Italy's tax system more closely with that of the other EC Member States in anticipation of events (that is, greater cross-border transactions) expected to transpire as from 1993. However, the Decree-Law was severely criticized, partially because of technical defects and largely because of the confusion it engendered amongst taxpayers, tax advisors, and in the securities markets.¹²

7. See generally Liebman & De Boeck, *Current Problems of Intercompany Financing*, 69 J. TAX'N 408, 410 (1988).

8. See 24 Tax News Serv. (IBFD) 360 (Dec. 19, 1990).

9. See Int'l Herald Trib., Oct. 2, 1990, at 11, col. 1; Int'l Herald Trib., Sept. 29-30, 1990, at 9, col. 2; see also 24 Tax News Serv. (IBFD) 143 (May 16, 1990).

10. See Marino, *Italy: Cross Border Dividends—The Treatment of Dividends Distributed to Non-Resident Shareholders*, 30 EUR. TAX. 42 (Feb. 1990).

11. 24 Tax News Serv. (IBFD) 269 (Sept. 5, 1990).

12. See generally Vigliano, *Italy Brings in Capital Gains Tax*, 9 INT'L FIN. L. REV. 37 (1990).

Although the new rules entered into force immediately on a temporary basis, Italian administrative law procedures resulted in their resubmission at least twice (as of the date this report was prepared) because the Italian Parliament failed formally to pass the Decree into law within sixty days of its issuance. In the course of resubmission, some technical details were clarified in the rolled-over Decree-Law of November 23, 1990, which took effect on November 29th,¹³ and substantive changes were proposed at the time of the second resubmission on January 28, 1991.¹⁴ Most importantly as to the latter, the differentiation between short- and long-term capital gains tax rates was dropped, and instead, two alternative methods of calculating the tax—a 20 percent withhold based on straight gain and a 25 percent tax on net gain—were allowed as options to be chosen by taxpayers.¹⁵ This particular story will no doubt continue.

Another important development relates to the ongoing saga as to the taxation of mergers and reorganizations in Italy, notably following the challenges (including that by the EC Commission) to the so-called "Enimont" Decree.¹⁶ New bills on the subject continued to wend their way through the legislative process, both at the Italian Ministry of Finance and the Finance Committee of the Italian Lower House of Parliament.¹⁷ In the meantime, at least one measure was actually adopted in this field. It allows the authorities to deny certain tax benefits—most notably the tax-free write-up of goodwill—arising from transactions that are primarily tax-motivated and lacking in economic purpose.¹⁸ The provision, which shifts to the taxpayer the burden of proof for claiming such tax advantages, applies to transactions effected since October 30, 1990. As it is quite broadly worded, taxpayers should be on guard as to potential challenges against the tax impact of any reorganization of their Italian groups.

IV. Luxembourg

Luxembourg has formally enacted further tax cuts as from January 1, 1991, reducing the normal corporate tax rate from 34 percent to 33 percent (leaving aside surtaxes and miscellaneous changes). It has also proposed legislation to promulgate the EC Parent-Subsidiary Tax Directive¹⁹ so as to accord wholly tax-free status for dividends received by even ordinary Luxembourg companies. The legislation thus would extend the participation exemption for pure holding companies to all Luxembourg companies. In order to qualify, the Luxembourg corporate shareholder must own at least 10 percent of the dividend payor's capital or at least

13. Daily Tax Rep. (BNA) No. 229, at G-2 (Nov. 28, 1990).

14. *Id.* No. 19, at G-1 (Jan. 29, 1991).

15. These descriptions are simplified. Readers should consult the actual law for details.

16. *See, e.g.*, 23 Tax News Serv. (IBFD) 302 (Dec. 20, 1989); *id.* at 290 (Nov. 29, 1989).

17. 24 Tax News Serv. (IBFD) 85 (March 21, 1990); Europe No. 5170 (n.s.), at 10 (Jan. 10, 1990).

18. *See* 2 TAX NOTES INT'L 1260 (1990).

19. EC Council Directive No. 9/435, O.J. No. L/225, Aug. 20, 1990, at 6.

a F.Lux. 50 million (approximately U.S. \$1.67 million) shareholding interest (at book value) for an uninterrupted period of at least twelve months before the end of the accounting year during which the dividends are paid.²⁰

Other proposed changes would extend the participation exemption to the capital gains realized on the disposal of qualified shareholdings (aligning Luxembourg with the otherwise more favorable Dutch regime) and the abolition of withholding on intra-EC dividends through the aforesaid EC Parent-Subsidiary Tax Directive.²¹ Clearly, Luxembourg is making a bid to compete actively with the Netherlands as a pan-European holding company jurisdiction so as to remain a competitive location, in general, within the future single European market.²²

V. The Netherlands

A number of recent decisions of various Dutch courts warrant notation, and should be borne in mind for their jurisprudential value.

A. TAXATION OF CORPORATE DIRECTORS' FEES

In a decision of the Lower Court of the Hague,²³ a U.S. corporation acting as the sole managing director of a Dutch corporation, and performing its activities in such capacity outside of the Netherlands, was found not to maintain a permanent establishment in the Netherlands. Under domestic Dutch statutory law, the compensation paid to such a nonresident corporation would be subject to corporate income tax as director's fees. However, the business profits provision of article III of the Dutch-U.S. Income Tax Treaty of April 29, 1948, as amended, prevents the Netherlands from imposing tax in this case since industrial and commercial profits of a U.S. corporation are exempt from Dutch tax unless the corporation maintains a permanent establishment in the Netherlands. The term, "industrial and commercial," is defined in article III so as to exclude income from personal services otherwise dealt with in article XVI, but that latter provision only covers income from personal services accruing to individuals and not income of corporations. The decision is in line with a decision of the German Bundesfinanzhof, dated July 7, 1971, dealing with a similar issue under the previous German-U.S. Income Tax Treaty of July 27, 1954, as amended.

B. LOSS OFFSETS

A recent Dutch Supreme Court decision²⁴ dealt with the complex issue of how to account for loss offsets in a treaty context. In the case at issue, a Dutch

20. 3 TAX NOTES INT'L 39 (1991).

21. See Int'l Tax Plan. Man. (CCH) No. 27, at 6 (Dec. 7, 1990).

22. See Doing Bus. in Eur. (CCH) No. 218, at 5 (Sept. 4, 1990).

23. Judgment of Apr. 19, 1989, BNB 1990/353.

24. Judgment of Feb. 28, 1990, BNB 1990/178.

resident had earned income from U.S. activities, but suffered losses in Belgium. The Court decided that the exemption for income taxable in the U.S. could only be applied after reduction for the Belgian loss.

As the Dutch-U.S. Income Tax Treaty refers to the domestic law of the taxing state for computing the amount of the exemption, and as Dutch internal law applies the so-called "overall method" for computing loss consolidation, the Court did not accept the argument that the relevant domestic provision explicitly states that it does not apply to the extent another double taxation arrangement (in this instance, the Netherlands-Belgium Income Tax Treaty) applies. Under this interpretation, the Belgian must first be offset against otherwise-exempt U.S. income and is thus used up in a wholly tax-inefficient manner.

C. TAXATION OF DIVIDENDS TO NONRESIDENTS

Finally, a third recent case of note²⁵ entailed a corporation organized under the laws of the Netherlands, but effectively managed and controlled—and taxable—in Ireland. For purposes of the Dutch-Irish Income Tax Treaty of February 11, 1969, as amended, the corporation was to be considered a resident of Ireland. In addition, it derived no income from the Netherlands.

Nonetheless, the Lower Court of The Hague decided that when such a company paid a dividend to its U.S. parent, it was subject to the five-percent Dutch withholding tax provided for in article VII of the Dutch-U.S. Income Tax Treaty of April 29, 1948, as amended. The court did not agree with the taxpayer that the Netherlands was prohibited from taxing the dividend under article 8, section 9 of the aforesaid Dutch-Irish Treaty, which provides that if a corporation is a resident of Ireland and derives income from the Netherlands, the latter may not tax dividends paid by the corporation to persons not residents of the Netherlands. The corporation argued that this provision applies, a fortiori, where the corporation did not even derive any income from the Netherlands. The court, on the other hand, decided that article 8, section 9 for that very reason did not apply.

VI. Switzerland

The Swiss Federal Parliament recently enacted new legislation intended to combat organized crime, and money laundering in particular.²⁶ The new provision entered into force on August 1, 1990. Broadly, it prohibits and punishes, by fine or imprisonment, any act that inherently impedes the identification of the source, discovery, or confiscation of assets that are known or should be known

25. Lower Court of The Hague, Judgment of Oct. 30, 1990 (decision appealed).

26. STGB, CP, CP art. 305 bis (1990). *See also id.* art. 305 ter (1990) (companion legislation requiring professionals in the financial services sector to verify the identity of the beneficial owner of funds with which they deal).

to have emanated from a criminal source. The provision distinguishes and more severely punishes "serious cases," which are defined (nonexclusively) as subsisting when the perpetrator: (a) acts as a member of a criminal organization; (b) acts as a member of a gang formed to systematically engage in money laundering; or (c) makes a profit or significant gains in engaging in money laundering by profusion. Punishment in serious cases can be severe, with a maximum prison term of up to five years and a concurrent fine not to exceed one million Swiss francs (approximately U.S. \$800,000).

It should be noted, however, that the new law is concerned with assets derived from a "crime," as that term is defined under Swiss law. By implication, assets or profits resulting from misdemeanors would not fall within the scope of this new legislation. Thus, for instance, since tax evasion is not a crime under Swiss federal law, the previous Swiss position as regards dealings by professionals in the "black money" of their clients would seem to remain intact.

VII. Miscellaneous

Corporate groups seeking to utilize interest-free loans in their European financing arrangements, or seeking to forgive loans to affiliates in financial difficulties locally, should be aware of two decisions recently rendered by the European Court of Justice (not yet published). They relate, respectively, to the payment of capital duty in the context of interest-free loans and the cancellation of debt. In both cases the Court decided that capital duty may indeed be levied. In the case of an interest-free loan, the duty is due on the amount of interest that would have been paid in an arm's-length transaction. In the case of a debt cancellation, duty is apparently due on the amount of debt which is forgiven.²⁷

27. See Eur. No. 5426 (n.s.) at 9 (Feb. 7, 1991); Eur. Rep. No. 1650, at II-2 (Feb. 6, 1991).