REGIONAL DEVELOPMENTS

European Tax Law*

I. European Community (EC)

The EC Commission has recently proposed several amendments to a number of EC Community Council directives on direct (corporate income) taxation.

A. Interest and Royalty Withholding Tax Exemption

The first proposal relates to the proposed Directive on Interest and Royalty Withholding Tax.[1] This directive would basically eliminate the withholding tax on interest and royalties paid between EC-based subsidiaries and EC-based parent companies owning at least 25 percent of the payor's stock. Although commentators had suggested that the original proposal be expanded to cover interest paid between typical brother-sister companies, the latest proposed amendments unfortunately do not do so.[2]

Rather, the amendments merely clarify that the terms "interest" and "royalty payments," are to be considered as defined under relevant double taxation conven-

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1. Proposal for a Council Directive on a Common System of Taxation Applicable to Interest and Royalty Payments Made Between Companies and Subsidiaries in Different Member States, 1991 O.J. (C 53) 26. *See generally* 18 Tax Plan. Int'l Rev. 36 (1991).

2. Amended Proposal for a Council Directive on a Common System of Taxation Applicable to Interest and Royalty Payments Made Between Companies and Subsidiaries in Different Member States, COM(93)196 final.

tions. The definitions under the double taxation conventions tend to be broad. Hence, these changes are a positive development in terms of ensuring the broadest possible scope of the proposal, even if they do not go far enough in recognizing the current methods of intragroup financing within the Community. The precise text, however, is disappointing given that the new draft was expected to allow interest and royalties to be exempt from withholding tax if paid to any EC-based companies subject to tax within the Community.

B. PARENT-SUBSIDIARY AND MERGERS (TAX) DIRECTIVES

The second document sets out proposed amendments to the Parent-Subsidiary and Mergers (Tax) Directives.[3] The amendments are in part, not wholly unforeseen; however, they include one rather interesting addition. As has long been expected, the basic thrust of the first of these proposals expands the scope and application of the directives beyond the present list of companies indicated in the respective annexes. The specific goal is to allow for cooperatives and other corporate entities subject to company tax, regardless of their precise legal form, to take advantage of these directives.[4]

The second proposed amendment inserts an element of parallelism between the two directives.[5] Presently, the Parent-Subsidiary Tax Directive sets out a minimum level of a 25 percent holding, but allows Member States to extend the benefits to parent companies holding less than 25 percent of a subsidiary. The EC Member States have, for the most part, enacted a 25 percent shareholding requirement when implementing the Parent-Subsidiary Tax Directive. The exceptions are the United Kingdom (with a 10 percent threshold), France (with a lesser of 10 percent or FF150 million threshold), and Belgium (with a new threshold of 5 percent or BF50 million in value).

By contrast, the Mergers (Tax) Directive requires that Member States exempt from tax the cancellation of shares in connection with an intragroup reorganization only when the participation exceeds 25 percent.[6] The precise text of the proposed amendment would not require that the threshold levels be the same as between the two directives, but would merely allow Member States to utilize the same standards if they wish.

A third proposed change specifically concerns the Parent-Subsidiary Tax Directive. This proposal would require that if a country implements the directive in such a fashion as to elect the foreign tax credit method of avoiding double taxation

3. Proposal for a Council Directive Amending Directive 90/434/EEC of 23 July 1990 on the Common System of Taxation Applicable to Mergers, Divisions, Transfers of Assets and Exchanges of Shares Concerning Companies of Different Member States, 1993 O.J. (C 225) 3-6.

4. EC Press Release IP (93) 637 (July 27, 1993).

5. *See generally* Nigel Tutt, *EC Commission Proposes Expanding Mergers and Parent/Subsidiary Directives*, 7 TAX NOTES INT'L 391 (1993); EUROPE No. 6031, July 29, 1993, at 8.

6. Council Directive 90/434, art. 7(2), 1990 O.J. (L 225) 1, 3.

rather than the exemption method, foreign tax credits must not only be extended to cover direct foreign tax credits (relating to the mainstream and withholding taxes paid at the subsidiary level), but also the corresponding corporate taxes paid down through the chain of any sub-subsidiaries. This change will be of particular interest to groups with the top parent located in Ireland, Spain, or the United Kingdom, all three being jurisdictions which utilize a foreign tax credit method for avoiding double taxation. It is noteworthy that the foreign tax credit would extend past the three tiers currently allowed under U.S. law.[7]

II. Austria

Significant tax reform is expected in 1994.[8] Highlights include:

(i) the elimination of the country's net wealth and trade taxes;

(ii) an increase in the corporate tax rate from 30 to 34 percent (although with the elimination of the trade tax, the overall corporate tax burden will actually decrease);

(iii) an increase in the payroll tax and the imposition of such tax on all employers, regardless of the number of employees;

(iv) modernization of the estate and gift tax laws (with details to be announced in 1994);

(v) an increase in the "insurance tax" on life insurance from 3 to 5 percent; and

(vi) an increase of the minimum taxable base on which the turnover tax is to be imposed, from 40,000 to 300,000 Austrian schillings (approximately US$3,400 to 25,300).

In the meantime, Austria has now relaxed (if not eliminated) the tight exchange controls and currency restrictions that have for many years burdened its businesses and investors. Austrians are now free to open bank and savings accounts and borrow abroad, although they must declare all foreign bank accounts to the Austrian National Bank, including the location of and turnover in such foreign accounts, deposits, and other transactions. Austrian enterprises may now issue bonds abroad without the permission of the National Bank. Additionally, foreign securities may now be freely purchased and transferred, and security accounts in which securities were to be deposited are no longer mandated.

The law still permits anonymous bank accounts for Austrian residents. However, nonresidents must provide their name and signature, and present proof of identification. In accordance with international money laundering standards, fiduciaries must disclose the identity of their foreign principals.

7. 26 U.S.C. § 902(b) (1993).
8. *See also* 4 WORLD TAX NEWS, July 1993, at 5.

III. Germany

In July 1993 the two houses of the German Parliament approved the Tax Act (*Standortsicherungsgesetz*) of 1994, making a number of modifications to the Corporation Tax Law (*Körperschaftsteuergesetz* or KstG).[9] In addition to reducing tax rates, the statute will add a new section 8a to the KstG that will finally introduce statutory thin capitalization rules. The new rules are aimed at foreign shareholders in German companies and may have a significant impact on their financing arrangements.[10]

The proposed legislation will apply to debt owed by German resident corporations to nonresident shareholders owning more than 25 percent of the debtor's capital. Interest paid on such debt will be reclassified as dividends (thereby denying the payor an interest deduction and in many cases subjecting the recipient to a higher level of withholding tax) unless:

(i) the debt consists of short-term financing (such as an installment obligation issued in connection with a deferred payment sale of merchandise); or

(ii) the debt is not participating (hybrid) debt and is used to finance transactions of a type usually effected by banks; or

(iii) the debt is not participating debt and the payor can establish that it could have obtained the loan on identical terms from an unrelated lender; or

(iv) the debt is not participating debt and the principal amount is more than three times the lender's equity (that is, a 3:1 debt equity ratio is surpassed) in the debtor corporation (nine times or 9:1, in the case of a holding company); or

(v) the debt is participating debt and the principal amount is more than one-half the lender's equity (that is, a 5:1 ratio is surpassed) in the debtor corporation (although a higher threshold may apply in the case of a holding company); or

(vi) the debt is participating debt and was incurred before December 9, 1993 (this "safe haven" only applies for taxable years ending before December 31, 1997).

The German legislation contains "anti-abuse" provisions designed to address issues such as related-person guarantees of third-party debt, "back-to-back" loans, and the use of German partnerships or permanent establishments as nominal lenders.[11]

IV. The Netherlands: Recent Dutch Case Law

(a) A corporation was organized under the laws of the Netherlands, but effectively managed and controlled—and taxable—in Ireland. For purposes of the

9. *See generally* Jacob, *Germany: Administrative and Legislative Developments of Interest to U.S. Tax Advisers*, 47 BULL. INT'L FISCAL DOCUMENTATION 383, 386-88 (1993); Richard E. Minor, *Significant Changes Under the New German Tax Act Explained*, 7 TAX NOTES INT'L 147 (1993).

10. Minor, *supra* note 9, at 150.

11. For a cogent critical analysis of these new rules, see Eugen Bogenschütz & Erich Pugh, *Germany's New Thin Capitalization Rules Examined*, 7 TAX NOTES INT'L 305 (1993).

Dutch-Irish Income Tax Treaty of February 11, 1969, as amended (the Dutch-Irish Treaty), the corporation was a resident of Ireland. It paid a dividend to its U.S. parent. The lower court of The Hague decided that the 5 percent withholding tax provided for in article VII of the Dutch-U.S. Income Tax Treaty of April 29, 1948, as amended, applied to the dividend since it was paid by a Dutch corporation.

On appeal, the Supreme Court held that the Netherlands was prohibited from taxing the dividend under article 8, § 9 of the Dutch-Irish Treaty. That article 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 Court decided that this provision applies, a fortiori, where the corporation did not derive any income from the Netherlands. It referred to the commentary to the OECD Model Income Tax Treaty which provides that the provision in question seeks to prevent extraterritorial taxation of dividends.[12]

(b) A Dutch resident corporation attracted new equity to invest in mortgages secured by Canadian real estate. The interest paid on such mortgages was, in the year under consideration, exempt from Dutch tax under the Dutch-Canadian Income Tax Treaty of May 27, 1986. It paid a 1 percent capital contribution tax on the issuance of the new equity.

Although costs incurred to generate exempt income must be allocated to such income, the Supreme Court held that capital duty does not have to be so allocated. The Court held that the cost was incidental to the legal formation of a corporation and depended on the amount of equity and not on the way the parties invested such equity. Therefore, the Court held that no direct link existed between the tax itself and any exempt income.[13]

(c) A Dutch resident corporation owned U.S. real estate. To acquire the U.S. real estate, it had incurred a loan denominated in Dutch guilders. When the corporation repaid the loan, the U.S. dollar had appreciated against the Dutch guilder. Therefore, when the parties calculated the income of the U.S. branch in U.S. dollars, the U.S. branch showed a gain (because repayment of the Dutch guilder loan required fewer U.S. dollars than could have been bought when the loan was incurred).

For Dutch tax purposes taxable income is calculated in Dutch guilders, but the exemption for foreign branch income must be calculated in the currency of the country of the branch. Although the foreign exchange gain does not arise in the calculation of the corporation's worldwide taxable income (because it is calculated in Dutch guilders), the Dutch Supreme Court held that the gain increases the amount of exempt income.[14]

12. Judgment of Sept. 2, 1993, Dutch S. Ct., Beslissingen Nederlandse [BNB] 1992/379, *rev'g* Judgment of Oct. 30, 1990, Lower Ct., The Hague, *noted in Regional Developments: European Tax Law*, 25 INT'L LAW. 755, 760 (1991).

13. Judgment of Mar. 11, 1992, Dutch S. Ct., BNB 1992/170.

14. Judgment of Mar. 10, 1993, Dutch S. Ct., BNB 1993/209.