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.

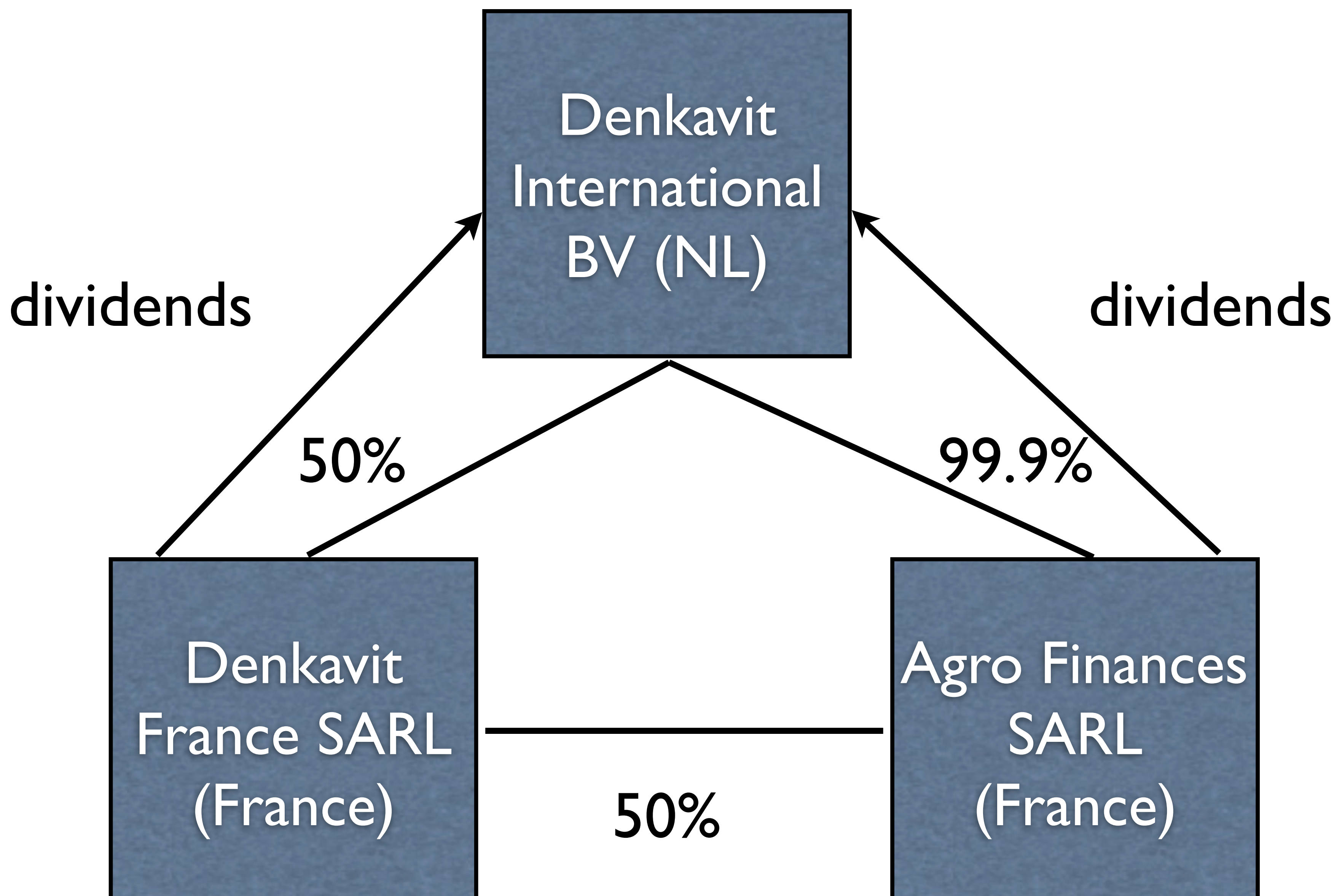
Background: ECJ

- 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.

Background: ECJ Case-Law

- 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 1986 (*Avoir Fiscal*), virtually universal unawareness of EC Treaty's relevance for direct taxes.
- 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 (C-170/05)

- Referred by France on 12/15/2004; AG opinion issued on 4/27/06, ECJ's ruling issued on 12/14/2006.
- 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.

Denkavit (C-170/05)

- 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.

Denkavit (C-170/05)

- 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.
- Referred by UK on 8/25/2004, AG opinion issued on 2/23/2006, ECJ's ruling issued on 12/12/2006.

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.

ACT Group Litigation (C-374/04)

- 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)

- Referred by UK on 10/13/2004, AG opinion issued on 4/6/2006, ECJ's ruling on 12/12/2006.
- 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.

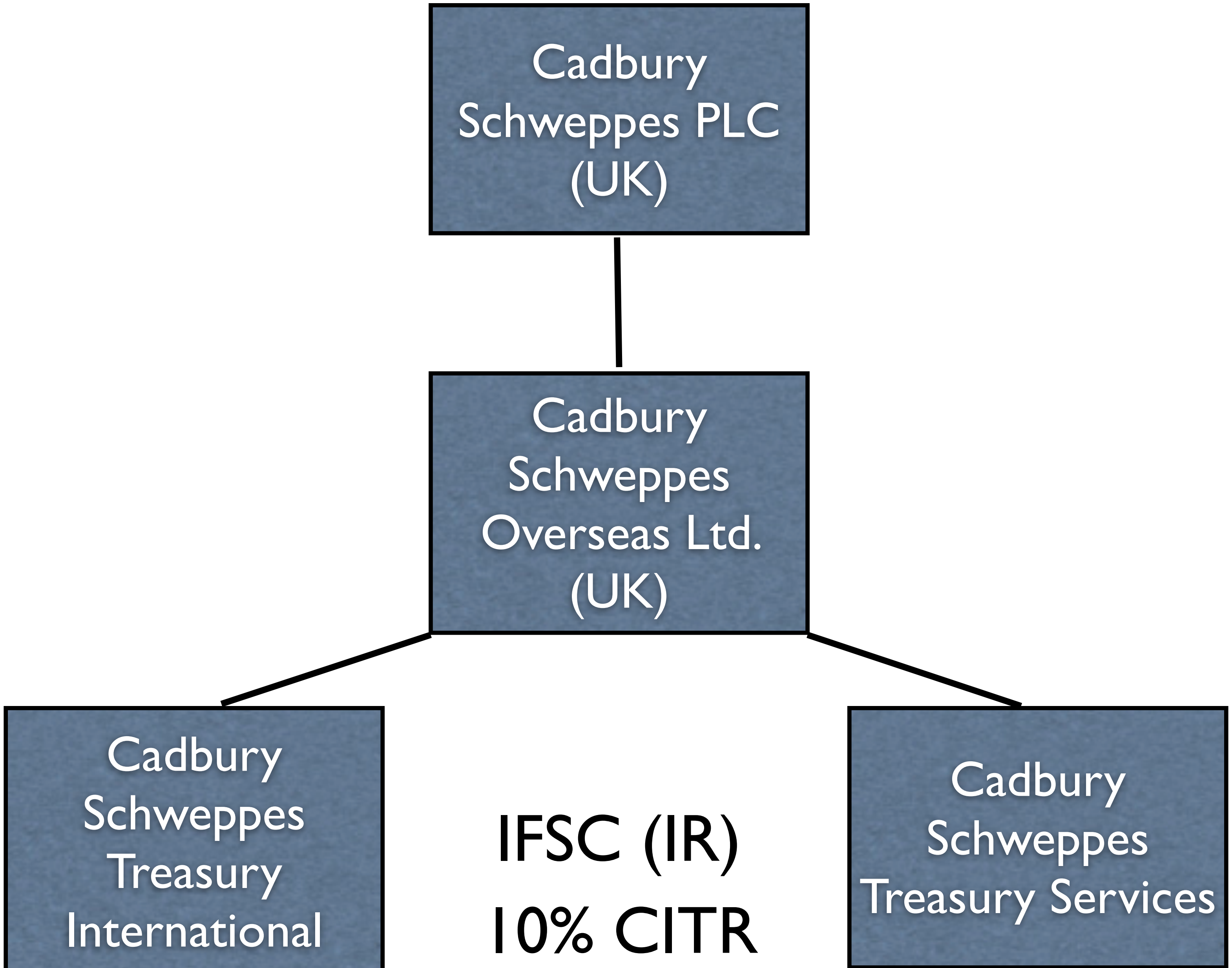
FII Group Litigation (C-446/04)

- 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)



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.

Cadbury Schweppes (C-196/04)

- 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)

- ‘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).

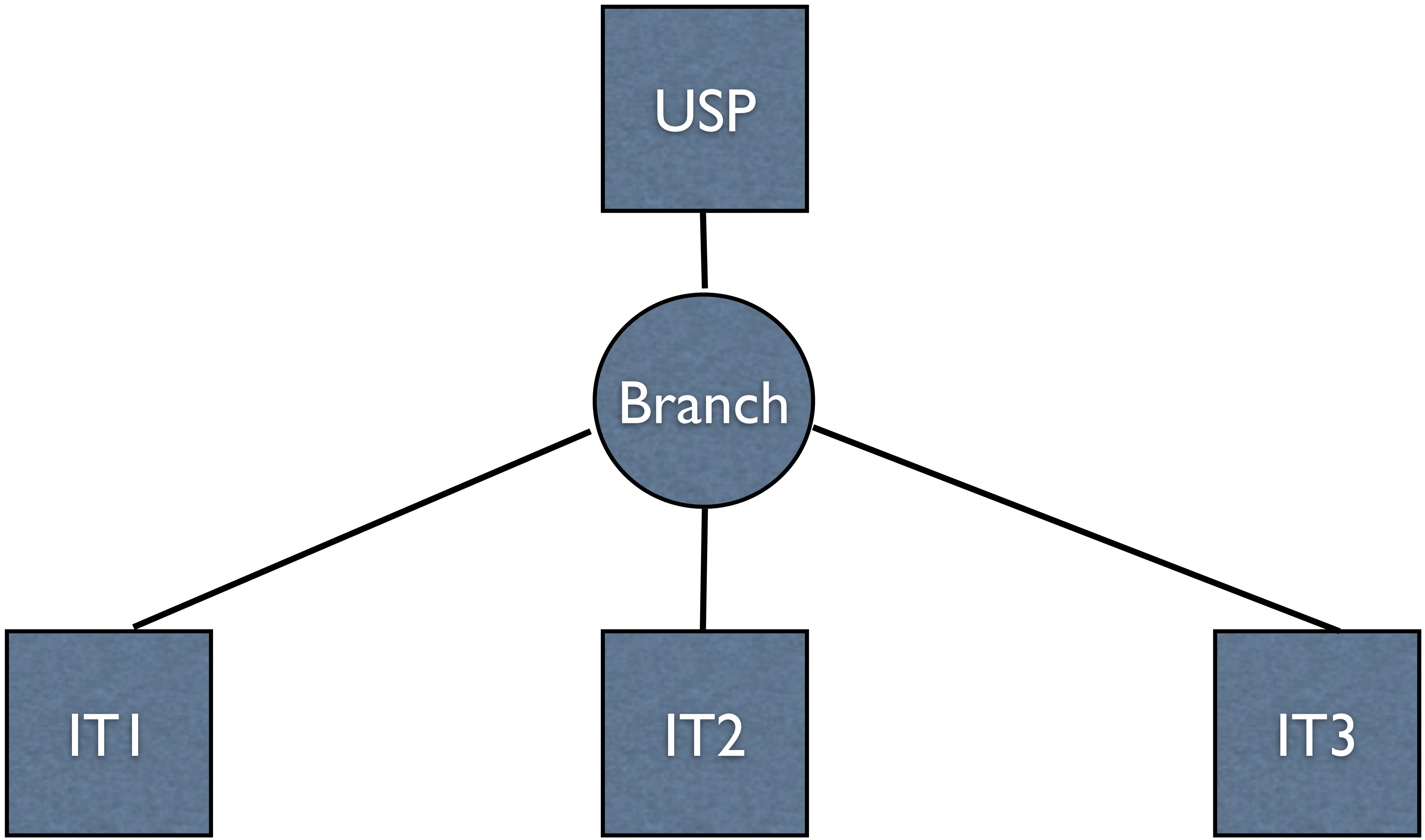
Italian Thin-cap Rules

- 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



Keller Holdings (C-471/04)

- ECJ's ruling issued on 2/23/2006.
- 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?