<u>Question 1</u>

Direct taxation is a competence that remains with the Member States of the European Union. This is clear from the provisions in the Treaty of the European Union, namely article 4.

Nevertheless, the Member States shall refrain from any measure which would jeopardise the attainment of the Union's objectives. These objectives include the establishment of the internal market, which encompasses the free movement of goods, persons, services and capital (as established in article 26 of the Treaty on the Functioning of the European Union - TFEU).

It is against these fundamental freedoms that the legislation of the Member States is examined. One of the main and general characteristics is that any discrimination on grounds of nationality is prohibited (article 18 TFEU), and this is important when evaluating the case of dividend withholding tax and the different consequences for resident and non-resident shareholders.

The first step in this evaluation is to establish which of the fundamental freedoms is at stake.

Freedom of establishment and freedom of movement of capital

In general, freedom of establishment (article 49 of the TFEU) will be applicable to situations where a shareholder has a holding in the capital of a company established in another Member State which gives him definite influence over the company's decision (see Baars case - C-251/98). This will be the case when a shareholder has the majority of the share capital of a company.

So called portfolio investments, where the shareholder does not own the majority of the share capital of the company, will be treated under the freedom of movement of capital, established in article 63 of the TFEU (see Verkooijen case - C-35/98).

This is an important fundamental freedom, as it establishes that all restrictions on the movement of capital are prohibited and it applies also between Member States and third countries. However, article 65 of the TFEU allows the Member States to make a distinction between tax payers who are not in the same situation with regard to their place of residence or place where their capital is invested. This distinction cannot, however, be arbitrary (see Verkooijen case).

Levy of dividend withholding tax

The taxation of outbound dividends can be problematic in terms of the application of the fundamental freedoms. It must be stressed that although direct taxation falls within the competence of the Member States, they must exercise that competence consistently with EU Law, as the Court has mentioned several times.

Legislation that establishes the levy of withholding tax on dividends may have the effect of dissuading nationals of a different Member State from investing their capital in resident companies and may make it difficult for resident companies to attract non-resident shareholders.

This is especially problematic once a Member State provides certain relieves (for example, tax credits) to resident shareholders, which in practice offset the taxation of the distributed dividends, but does not provide the same relieves for non-resident shareholders.

The Court of Justice of the European Union (Court) has addressed the issue of imposing a withholding tax on dividends in a number of cases, where the main criteria seems to be whether the resident and non-resident shareholders are in a similar position or not.

Case law

In the cases Denkavit Internationaal (C-170/05) and ACT Group Litigation (C-374/04), the Court admitted that resident and non-resident shareholders are not necessarily in a comparable situation.

The resident and non-resident shareholders are not in a comparable situation in those cases where the Member State does not impose a tax liability on the dividends paid to non-resident companies (see FII Group Litigation case - C-446/04).

However, when a Member State imposes a charge on the income on both resident and non-resident shareholders (for example, imposing withholding tax), the situation of the non-resident shareholders becomes comparable to that of resident shareholders.

In this case, any relief made available to resident shareholders, must be available to non-resident shareholder as well.

The Court concluded that national legislation which imposes a liability to tax on dividends paid to a non-resident company, while allowing resident companies almost full exemption from such tax constitutes a discriminatory restriction on the fundamental freedom of establishment (Denkavit case).

Question 2

According to the case law of the Court of Justice of the European Union (Court), a statutory tax provision that hampers the exercise of one of the fundamental freedoms can only be justified by certain narrow constructed reasons. One of these reasons is the need to combat tax avoidance.

General anti-abuse principle

The existence of a general anti-abuse principle in EU Direct tax Law has been greatly discussed and has been under the evaluation of the Court.

The application of anti-abuse measures in the area of direct taxation has also been object of a Communication from the Commission (2007).

A general anti-abuse principle has been accepted in other field of the EU Law, namely in the field of indirect taxation (see Halifax case). Here the court has accepted that a specific transaction may be questioned by a Member State in the specific case where:

a) The tax advantage was the main goal of the specific transaction;
b) The transaction will give a tax advantage that would not be available otherwise and is contrary to the EU Law.

As noted by the Commission in its 2007 Communication, some Member States apply a general concept of abuse, while others apply more specific anti-abuse provisions (for example, CFC or thin capitalisation rules).

Case Law

The Court has addressed some cases which include the application of anti-abuse provisions that restrict the fundamental freedoms established in the TFEU.

<u>CFC rules - Cadbury Schweppes case (C-196/04)</u>

This is a landmark case in terms of anti-abuse provisions. Here the Court addressed the UK's CFC legislation and concluded that the mere existence of an advantage (low taxation) or the establishment of a subsidiary in another Member State cannot setup a general presumption of tax evasion.

In order for a statutory provision that limits a fundamental freedom to be justified on the ground of prevention of abusive practices , the specific objective of such provision must be to prevent the creation of wholly artificial arrangements which do not reflect economic reality.

In order to find that such arrangement exists, it is necessary to consider the subjective element (intention to obtain the tax advantage), but also objective circumstances surrounding such arrangement.

The fact that the anti-abuse provision must be specifically directed towards preventing wholly artificial arrangements (and not apply generally) was also mentioned in Lankhorst-Hohorst case (C-324/00).

Thin Capitalisation rules - Thin Cap case (C-524/04)

This case examined UK's thin capitalisation rules. Once again the Court stressed the importance that statutory tax provisions are targeted to the practice of thin capitalisation and do not apply arbitrarily.

Here the Court also found that national legislation providing for a consideration of objective elements in order to determine whether the arrangement is artificial or not, is to be considered as not going beyond the necessary to prevent abusive practices, and, therefore, it is compatible with the fundamental freedoms.

Specifically, the fact that the taxpayer is given an opportunity, without being subject to undue administrative constraints, to provide evidence of any commercial justification.

This means that the taxpayer must have an opportunity to demonstrate the economic reason behind a specific operation.

From the abovementioned cases we can conclude that in order to be justified, an anti-abuse provision must target wholly artificial arrangements and must be proportional, allowing taxpayer to produce evidence of any commercial justification.

Question 4

When the Court of Justice of the European Union (Court) is evaluating a tax provision that constitutes a restriction to one of the fundamental freedoms, it will consider whether the tax provision is proportional or not.

According to the case law from the Court, the proportionality principle includes two aspects:
1) the tax provision must be adequate to address the specific objective pursued; and,
2) the tax provision does not go beyond the necessary to attain the objective pursued.

Case law

The Court has addressed the issue of proportionality in cases regarding cross border loss relief.

Lidl Belgium case (C-414/06)

This case had to do with cross border loss relief in case of a permanent establishment in Luxembourg of a German company. The deduction of the losses of a permanent establishment was refused, on the basis that there was a risk that the losses were taken into account twice.

The Court found that the German regime was appropriate for ensuring the attainment of the objectives pursued.

While evaluating whether the regime goes beyond what is necessary to attain the objectives pursued, the Court made reference to its previous judgement Marks & Spencer, where it was found that a regime goes beyond what is necessary where a non-resident subsidiary has exhausted the possibilities for having the losses incurred in the Member State where it is located taken into account.

As in the Lidl Belgium case the Luxembourg tax legislation provided for the possibility to deduct the losses in future tax years, the German tax provision was considered proportional.

Krankenheim case (C-157/07)

Also in the context of a case about cross border loss relief, this case had to do with a German tax system that allowed the deduction of losses of a permanent establishment in another Member State, on the condition that future profits of such permanent establishment would be reintegrated.

Here the Court found that the measure was appropriate and proportional, as the system operated in a symmetrical manner.

On the contrary, in Nordea case (C-48/13), the Court found that the reintegration regime at stake was not proportional, as the reintegration can only take place in so far as the Member state taxes the profits of the permanent establishment.

Question 8

The incompatibility of the state aid by Member States is established in article 107 TFEU.

State aid was the object of a Notice from the Commission (Notice of 11 November 1998 on the application of the State aid rules), where the Commission inserts its efforts regarding State aid in the form of tax measures in a wider context of the application of the State aid rules in order to reduce distortion of competition in the single market.

To be considered aid for the purpose of the TFEU, a measure must meet the following criteria:

1) The measure must confer on recipients an advantage which relieves them of charges that are normally borne from their budgets (for example, reduction in tax base or reduction in the amount of tax);

2) The advantage must be granted by the State or through State resources (which is the case of loss of tax revenue);

3) The measure must affect competition and trade between Member States (this criteria is met if the recipient company carries on economic activity involving trade between Member States); and,

4) The measure must be specific or selective in that it favours certain undertakings or the production of certain goods.

These criteria apply to the evaluation of the specific case of tax rulings. Some multinational companies seek tax rulings with some Member States in order to have a previous agreement on how certain transactions will be treated for tax purposes in that Member State.

In such case, the three first criteria set in the Notice from the Commission are usually filled. The open question relates to the selectivity of the measure. In case a tax ruling establishes a preferential tax treatment only available to that specific company, then it will be considered illegal state aid.

Question 9

The transfer of losses is dealt in article 6 of the Merger Directive.

This article establishes that, to the extent that such relief is available for domestic merger operations, the Member State shall allow the transfer of losses from the transferring company to the receiving company, as long as there is a permanent establishment of the receiving company in that territory.

The Court of Justice of the European Union (Court) has addressed the issue of the transfer of losses in the context of merger operations in several cases.

Foggia case (C-126/10)

This specific case had to do with the transfer of losses and the application of the anti-abuse provision of the Merger Directive (article 15). The Court established that the merger operation should have valid economic and commercial reasons. In case the only reason for such an operation was the transfer of the losses, then the anti-abuse provision may apply.

In this specific case, Company A was wound up and no permanent establishment of Company B exists in Xarilya. The Court has examined a similar case.

A Oy case (C-123/11)

In this case, the transferring company was also wound up and no permanent establishment of the receiving company remained. The Court found that it was incompatible with the EU Law for a legislation to not allow the parent company the possibility to show that its non-resident subsidiary has exhausted the possibilities of taking those losses into account.

Therefore, in this case, Company B would have to demonstrate that the losses recorded by Company A are final and cannot be offset in the future in Xarilya. If it is successful, then the losses from Company A may be offset in Yushia.