Chartered Institute of Taxation

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Suggested Solutions

PART A

Question 1

First of all it has to be established which treaty freedom is applicable here. If the situation concerns portfolio investments that do not give a decisive influence in the company, this issue does not relate to the freedom of establishment (Article 49 TFEU) but to the free movement of capital (Article 63 TFEU).

Under the case-law of the ECJ it constitutes a restriction of these fundamental freedoms if dividend withholding tax is levied from foreign taxpayers if it is not levied in respect of domestic taxpayers which are in the same situation (Denkavit, Amurta).

There can also be a restriction if foreign shareholders are subject to a different tax base and a different tax rate as domestic shareholders (In CJEU 19 January 2006, C-265/04, Bouanich). The Court ruled that on an individual basis, the actual tax burden had to be compared between a resident and a non-resident. If, at the calculating level, the tax burden of the non-resident taxpayer is higher than that of resident taxpayer, this constitutes a discriminatory treatment, and the difference in tax has to be refunded by the source state to the non-resident taxpayer (Bouanich, Miljoen, etc).

The ECJ does not accept as a justification the fact that the non-resident taxpayer is in a different position compared to domestic taxpayers (Art. 65, par. 1 TFEU). Such distinction constitutes an arbitrary means of discrimination (Art. 65, par. 3 TFEU).

The main question of course is what should be taken in consideration at the comparison level. If domestic taxpayers are subject to both DWT and (Corporate) Income Tax, whereas foreign shareholders are only subject to DWT, then in the comparison also the (corporate) income tax in the source state has to be taken into account (Miljoen).

In such case, for the purpose of the comparison, non-resident shareholders must be granted the same tax free base (Miljoen) and only costs related to the payment of dividends can be taken into account (not the costs of financing the shares) (Miljoen).

A restriction of a fundamental freedom can be neutralized by a “compensating” advantage granted by a foreign state. In that case, the exercise of the free movement is no longer discouraged.

The source state cannot rely in this principle of “neutralization” if the national law of the state of residence of the shareholder occasionally gives a credit for the foreign DWT and in such way provides neutralization of the DWT (Amurta – 8 nov 2007). For example if there is no tax treaty (Commission vs. Italy, Commission vs. Germany).

The source state can only rely on the principle of “neutralization” if it has concluded a tax treaty with the state of residence of the shareholder which obliges the state of residence to fully and effectively neutralize the disadvantage in the source state. It must be examined on a case-by-case basis whether the disadvantage is fully neutralized (Amurta; Denkavit 14 dec 2006).

If the treaty provision however, cannot be applied because the dividends are exempt, than the treaty does not justify the restriction. (Denkavit 14 dec 2006).

Question 2

From for instance the Halifax case (Case C-255/02), it can be derived that taxpayers may choose to structure their businesses in the most tax optimal way, so as to limit their tax liability. Therefore, on the basis of a business motive, while to structure this business arrangements various tax options are possible, the taxpayer may choose the tax wise most advantageous solution.

In literature a distinction has been made between an objective test and a subjective test of abuse. The objective test, following from the decision in the Emsland-Stärke case (Case C-110/99), the test is explained as ‘a combination of objective circumstances in which, despite formal observance of the conditions laid down by the Community rules, the purpose of those rules has not been achieved.’

The subjective test can be derived from case law like Halifax, Part Service, RBS Deutschland (Case C-277/09) and Weal Leasing. The Court speaks of ‘an artificial arrangement that does not reflect economic reality and the sole aim of which is to obtain a tax advantage.

In direct tax cases one is primarily dealing with the treaty freedoms of the TFEU. Within that area, the aspect of abuse comes into play in terms of a ground for justification and whether the measure as such is proportionate and suitable to combat abuse. In this respect special reference can be made to the famous Cadbury Schweppes-ruling of the ECJ (Case C-196/04) on UK CFC-legislation, in which the Court rules that such measures are allowed and justified provided that they are specially related to wholly artificial arrangements aimed at circumventing the application of the legislation of the Member States concerned.

In CJEU 22 May 2008, C-162/07, Ampliscientifica) the Court ruled that the principle prohibiting the abuse of rights is therefore to prohibit wholly artificial arrangements which do not reflect economic reality and are set up with the sole aim of obtaining a tax advantage (see, to that effect, Case C 196/04 Cadbury Schweppes and Cadbury Schweppes Overseas [2006] ECR I 7995, paragraph 55).

Abuse should be determined on a case-by-case basis, granting taxpayers to opportunity to provide counter proof (e.g. Leur-Bloem).. The purpose of obtaining tax advantages is not considered to be a commercial motive (Leur-Bloem, Foggia).

Anti-abuse measures that are generally applied and that also affect situations which are not abusive are not proportionate and cannot justify a restriction of the fundamental freedoms (Lasteyrie du Saillant).
It is, however, allowed that anti-abuse measures, such as transfer pricing rules, only apply in cross-border situations (SGI).

PART B

Question 3

Exit taxes are taxes which are levied when companies transfer either their residence or business assets to another state, as a result of which the state of origin loses its tax jurisdiction. In order not to lose existing tax claims, States impose exit taxes on latent capital gains in such situations. In many case rulings, the question was raised whether these exit taxes infringe the freedom of establishment.

In Daily Mail, the ECJ ruled that Daily Mail could not rely on the freedom of establishment when it transferred its seat from the UK to the Netherlands. The ECJ ruled that the state of residence determines whether a company that transfers its residence abroad maintains sufficient connections to the state of origin in order to be maintain its status as company of the state of origin. If the company loses such status, it cannot rely on the freedom of establishment.

In National Grid Indus, the ECJ ruled that if company law allows a company to transfer its tax residence (real seat) to another EU Member State, then that company exercises its freedom of establishment doing so. Any form of exit taxation must be in line with the freedom of establishment. This is examined under the Gebhard-line of reasoning.

In National Grid Indus, the ECJ ruled that, in principle exit taxation hampers the exercise of the freedom of establishment. However, this can be justified by the need to preserve a balanced allocation of taxing powers between member states and the cohesion of the tax system of a member State. Exit taxes are adequate to achieve that aim.

They must, however, also be proportionate. This means that:

- Payment of the exit tax can be deferred (as a choice of the taxpayer) until the moment of realization of the capital gains on assets;
- The state of origin may require guarantees;
- The state of origin may charge interest during the deferral of payment; and
- The state of origin is not obliged to take into account later decreases in value.

The ECJ gave similar rulings in case of the transfer of assets between PE and head office in different Member States.

In its later case law in respect of corporate reorganizations (DMC) the ECJ specified that it is also allowed that a Member State levies exit taxes if it loses its tax jurisdiction as a result of a cross-border reorganization. The ECJ specified that an exit tax is proportionate if:

- Payment takes place in 5 fixed annual instalments;
- Without interest payments; and
- With guarantees, but only in case of an actual threat of non-payment.

Question 4

In the Gebhard-ruling, the ECJ ruled that a measure that hampers one of the four freedoms can only be justified if it pursues an objective that as such can be justified. The measure must also be adequate to achieve that objective and not go beyond what is necessary (proportionality).

The reason for this proportionality requirement is that any exceptions to the fundamental freedoms must be interpreted strictly. Such measures are only acceptable if they are really necessary. If a measure does not actually contribute to the achievement of its objectives or if it has a broader scope than necessary, it cannot be said that the measure in that form is indispensable.

A measure is not justified either if it goes beyond what is necessary (e.g. Lasteyrie). This means for example:

- A measure is not proportionate if less restrictive measures are available;
- Its scope is too broad and also affects taxpayers or situations that do not need to be addressed (Lasteyrie);
- Losses cannot be deducted anywhere any more (M&S); or
- Personal allowances cannot be deducted anywhere (Schumacker).

In several cases, the ECJ has, implicitly or explicitly, ruled that a measure is not justified because it is not adequate to achieve the objectives aimed at. For example the ICI case, C-264/96. In the ICI-case, the UK Group Relief regime, which allowed to consolidate profits and losses of resident UK companies, did not apply to UK companies of a group of which the majority consisted of non-resident companies.

The ECJ, however, rejected the tax avoidance justification, noting that the legislation does not address wholly artificial arrangements, but applies generally to all situations in which the majority of a group's subsidiaries are established outside the United Kingdom. Furthermore, the ECJ ruled that the risk of avoidance is entirely independent of whether or not the majority of subsidiaries are resident in the United Kingdom; only one non-resident subsidiary is enough to create that risk.

Students may also present other ECJ cases in which the measure went beyond what is necessary or in which the measure was inadequate to achieve its aim.

PART C

Question 5

The case regards a different treatment of creditors resident in Avajal in case of domestic debtors versus non-resident debtors. In case the debtor is resident, the interest received is exempt, whereas the interest received is not exempt if the debtor is non-resident. This discourages creditors to grant loans to non-resident debtors compared to resident debtors. Such measure hampers the free movement of capital, art. 63 TFEU.

(As alternative: if this rule only applies to associated enterprises it can be argued that instead the freedom of establishment is at stake, cfr. Fidium Finanz).

Under Art. 65 TFEU, par. 1, sub a, a restriction of the free movement of capital can be justified if the tax law distinguishes between the place where the capital is invested. Art. 65 TFEU, par. 3 however provides that this does not allow any form of arbitrary discrimination. In practice, therefore, Art. 65 TFEU, par. 1, sub a, does not provide more justifications than the rule of reason does, cfr. Verkooijen.

The question is therefore whether this measure can be justified. That depends on the aim of the measure. From the case it follows that the aim of the measure is to avoid double taxation in case of interest payments which are affected by a thin cap rule. Obviously, double taxation can occur both in domestic and cross-border situations. There seems to be no reason to limit the exemption to only domestic situations. If the measure is aimed at combating tax avoidance in case of associated enterprises, the measure can be justified if in a specific case the loan is not based on the economic reality. Otherwise the measure is disproportionate (Itelcar, C-282/12).

Question 6

The case regards the free movement of workers, because John is going to work in another EU Member State. The applicable rules discourage John to work abroad, because he will benefit only partly from tax deductions related to his personal and family circumstances.

In the Schumacker ruling, the CJEU has ruled that for the purpose of deductions in personal income tax related to personal and family circumstances, as a rule, residents and non-residents are not in the same position. Consequently, non-resident workers are not entitled to the same deductions as residents.

This is different, however, if non-resident workers earn their entire income or almost their entire income in the work state and if they do not earn enough income in their state of residence to benefit in their state of residence from deductions related to their personal and family circumstances. Under those circumstances, the work state is obliged to grant non-resident workers the same deductions as resident workers.

Under such circumstances, a different treatment of resident and non-resident workers would constitute an indirect discrimination of nationals of other EU Member States on grounds of their nationality, because generally residents of a Member State are nationals of that Member State whereas non-residents generally are not. This would constitute an infringement of the free movement of workers (art. 45 TFEU). In the case Commission/Estonia, the CJEU clarified that the Schumacker ruling does not stipulate a strict 90% criterion, as certain scholars assumed. The case regarded a resident of Finland who received only 50% of her income from Estonia (pension payments). Despite of this, Estonia was obliged to grant her the same deductions for personal and family circumstances as it granted to residents, since the lady did not earn enough in Finland to make use of similar tax benefits in her state of residence.

This means that Member State Navaja is obliged to grant John these tax benefits, to the extent that he does not receive them in his state of residence. In his state of residence he benefits from a tax deduction of €10,000 (the maximum possible with his income from that state). That means that Member State Navaja must grant a deduction for the rest, i.e. for the amount of €2,000.

Question 7

Sports Co. is a company established under the laws of Member State Kastera, but with POEM in Member State Lorgrand. Apparently, the company has exercised its freedom of establishment to transfer its real seat abroad to another Member State.

If the corporate income tax rate in the state of origin Kastera is higher than in the state of the real seat Lorgrand, than it can be a disadvantage for Sports Co. that the treaty between both states allows the state of incorporation (Kastera) to tax Sports Co. as a resident taxpayer instead of state Lorgrand. This disadvantage applies because of the nationality (state of incorporation) of Sports Co. If the company had a different nationality, it would not be considered a resident of state Kastera. The question is whether this constitutes discrimination on grounds of nationality.

In the case Van Hilten van der Heijden, the CJEU has ruled that Member States are allowed to charge inheritance tax on the basis of the nationality of the deceased, being a national of that specific Member State. This is not considered as prohibited discrimination on the basis of nationality, but as legitimate taxation of a State's own nationals. This principle also applies to the domestic laws of State Kastera which consider Sports Co. a resident of Kastera.

Furthermore, in the Gilly case, the ECJ ruled with regard to the free movement of workers that Member States are allowed to divide the power to tax between Member States on the basis of the nationality of taxpayers. This does not constitute a form of prohibited discrimination. We can assume that the same applies with regard to the freedom of establishment.

Consequently, the tie-breaker rule of the tax treaty between Kastera and Lorgrand is in line with EU law.

Question 8

According to Article 107, paragraph 1 of the TFEU any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market. State aid rules apply regardless of the form the aid is given in, i.e. any kind of tax relief can constitute State aid if the other criteria are fulfilled.

In 1998, the Commission presented a 'Notice on the application of the State-aid rules to measures relating to direct business taxation', explaining how the State Aid rules should be understood in company taxation matters. According to that Notice, Article 107 sets out the following four tests to identify (fiscal) State aid contained in national (tax) measures:

1. Favourable (tax) treatment; this can be in any form, such as a special tax rate for certain companies, an exemption, special deductions, accelerated depreciation, special tax-free reserves, etc.;

2. At the cost of State resources: the advantage must be granted by the State or through State resources; this is generally the case if tax benefits are granted;

3. Affecting competition and trade between Member States; this condition is generally considered to be met if a company receives a benefit to which otherwise it would not have been entitled; and

4. Selectivity: the measure must be non-general, it must be specific or selective in a way that it favours 'certain undertakings or the production of certain goods'; this is the case if tax benefits are granted to individual companies.

Tax rulings are concluded between an individual company and a tax administration of a certain Member State. They often address issues like transfer pricing. Of course such a ruling should be based on norms accepted in the international tax arena and furthermore such a ruling should abide the at arm's length principle.

If such a ruling however deviates from the applicable tax laws and contains a specific tax advantage for the company as such that leads to a lower tax burden, this can be seen as providing state aid by the Member State involved in a hidden manner that is forbidden.

Question 9

The question regards Article 6 Merger Directive.

This provision gives in case of a cross-border merger – under conditions - the right to transfer losses from the company that is wound up (transferring company) to the absorbing company (receiving company). This, however, only applies on a non-discriminatory basis: the transfer of losses in cross-border mergers is only mandatory if, under domestic tax law, such transfer is allowed in case of a domestic merger.

Furthermore, the rights of Article 6 are subject to the condition that a permanent establishment remains behind in the state of the transferring company (that is wound up). Under Article 6, the losses suffered in the state of the transferring company may be transferred to the permanent establishment that remains behind in that same state (and that as a consequence of the merger will belong to the receiving company).

Article 6 does not grant the right to 'export' losses suffered in the state of the transferring company to the state of the receiving company. The state of the receiving company is not obliged to grant the possibility to compensate the losses suffered in the state of the transferring company. Since in the present case, after the merger, no permanent establishment remains behind in state Xarilya, Article 6 does not provide the right to transfer any losses.

A cross-border merger is a way to exercise the freedom of establishment, see A Oy case.

In the A Oy case (C-123/11) the CJEU has ruled that if the transferring company is wound up and there is no remaining permanent establishment in the state of the transferring company, and the losses cannot be used anymore in the state of the transferring company (nor by the transferring company, nor by any other company) then such losses can be considered as final losses under the freedom of establishment.

By analogy to the Marks & Spencer 2 case, and provided that loss transfer is possible in case of domestic mergers under the laws of the state of the receiving company, the state of the receiving company must allow that the foreign losses are compensated with profits in the state of the receiving companies. In such situations, the rules for loss compensation may not be less favorable than the rules that apply to domestic mergers in the state of the receiving company.

In the case at hand the losses of company A seem to be final losses. If state Yushia allows loss transfer in domestic mergers, it must also allow the 'import' of final losses in this case.