



VECO TAX

News

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EUROPEAN UNION

Withholding tax on dividends in the EU and freedom of establishment

The Denkavit II case

On 14 December 2006, the European Court of Justice delivered an interesting judgment on three requests for preliminary rulings put forward by the French national court. The ruling concerned a dispute relating to the distribution of dividends between companies resident in different EU countries (case C-170/05 Denkavit International BV vs Ministre de l'Economie, des Finances et de l'Industrie).

The key issue of the dispute referred to facts that occurred prior to the adoption of European Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries resident in different Member States. However, the ruling also establishes principles that are relevant in all cases in which the Directive is not applicable.

The issue regards the taxation of dividends distributed by a French company to a company resident in the Netherlands. The Dutch company held that French laws on the taxation of dividends are incompatible with EU law and in particular with article 43 of the EC Treaty (freedom of establishment).

French law imposes withholding tax on dividends paid to entities not resident in France, at the reduced rate of 5 per cent by virtue

of the provisions of a double tax agreement between the two countries, while none is levied on dividends paid to residents. In the case in question, the Court of Justice held that the difference in the tax treatment of dividends paid to EU shareholders violates the fundamental right under article 43 of the EU Treaty.

The host Member State cannot therefore discriminate against enterprises resident in another EU state by not allowing them to benefit from the same lower rate of taxation on dividends enjoyed by resident companies.

Several EU Member States (including Italy) continue to levy withholding tax on outbound dividend payments while domestic dividend payments are exempt. These countries will now have to amend their laws.

The Court of Justice also ruled that the existence of a double tax agreement does not exempt the contracting Member States from compliance with EU laws. France is not therefore allowed to apply to the provisions of a double tax agreement by way of justification for non-compliance with its obligations under the Treaty.

Pursuant to the judgment in question, articles 43 EC and 48 EC preclude national legislation that imposes a liability to withholding tax on dividends paid by a resident subsidiary to a non-resident parent company, even if the Member States concerned have entered into a tax agreement authorising said withholding tax and providing for said tax to be deducted from the

IN THIS EDITION:

EUROPEAN UNION

Withholding tax on dividends in the EU and freedom of establishment

1

CHINA

Tax reform

2

BELGIUM

New rules on the taxation of royalties and dividends

2

HUNGARY

Tax exemption to include capital gains

3

SWEDEN

Clarification of the holding regime

3

ITALY

Amendments to the taxation of cross-border dividend, interest and royalty payment

3

tax due in the parent company's country of residence.

Advocate General Mengozzi issued a similar opinion on the

Amurta case (C-379/05). This dispute regarded a violation of article 56 on the free movement of capital. The judgment appears to confirm the incompatibility of Dutch dividend withholding taxation with EU law.

CHINA

Tax reform

On 16 March this year the National People's Congress approved a set of tax reforms. As a result of the new laws, as from 1 January 2008 "foreign" businesses in China will no longer enjoy preferential tax treatment. The aim of the Chinese Government is to harmonise tax laws, so that the same rates are applicable to foreign and local enterprises.

The new regime marks the consolidation of two separate corporate income tax regimes for domestic-invested enterprises ("DEs") and foreign-invested enterprises ("FIEs") into a single regime. The aim is thus twofold: firstly, to consolidate the two existing tax regimes into a single law and unify the tax obligations for both groups of taxpayers; secondly, to harmonise the current situation with the unification of (i) the tax base, (ii) the so-called "preferential tax treatments" and (iii) the tax rates.

Resident companies will be taxed on their worldwide income, at a rate of 25 per cent (although small and high-tech enterprises will be taxed at reduced rates of 20 and 15 per cent respectively).

Prior to the reform, FIEs were taxed at rates varying between 10 and 24 per cent, depending on where they were located (there are two Special Economic Zones – SEZs – in China, which offer extremely favourable tax conditions for foreign investors).

It will be possible to evaluate the effects of the reform once the implementing regulations have been published.

Non-resident enterprises will be

taxed on their China-source income.

One point of particular interest which has yet to be defined regards the tax holiday benefits for newly established foreign-invested manufacturing enterprises in China. In the past, such companies were eligible for a two-year 100 per cent tax holiday followed by a 50 per cent exemption for another three years (commencing from the first fiscal year during which they reported a profit).

This form of incentive will no longer apply as from 1 January 2008. However, there will be a grandfathering system for enterprises in existence prior to 16 March 2007. These companies will be able to continue to benefit from the previous regime but the five-year tax holiday will commence immediately (1 January 2008), regardless of whether a profit is reported.

Another controversial aspect regards the withholding tax on dividends. Under the previous system dividends paid by an FIE to a foreign parent company could be remitted without attracting withholding tax. The reform could also introduce some form of taxation on dividends paid to foreign shareholders (probably at a rate of 20 per cent). Efficient tax structuring is therefore essential for those planning to invest in China. This must take into consideration the provisions of double tax agreements between China and other countries (those that provide for the lowest dividend tax rates are, among others, the agreements with Barbados, Hong Kong, Mauritius and Ireland).

Taxation of intercompany transactions

The reform also includes provisions concerning intercompany transactions. Under the decree, if an intercompany transaction does not comply with the arm's length principle and results in reducing the taxable income, the tax author-

ities will have the right to adjust the enterprise's taxable income. In this respect, an enterprise will be able to negotiate an Advance pricing agreement (Apa) with the tax authorities. In doing so the enterprise will have to indicate its pricing principles used in its intercompany transactions. All enterprises will be required to include details of related party transactions with their annual tax return. In the event of an investigation, the enterprise being investigated and its related parties must provide all the supporting documents requested by the tax authorities. In the absence of such supporting documents, or if the information is incomplete, the tax authorities will have the right to determine the taxable income.

BELGIUM

New rules on the taxation of royalties and dividends

Licence fees

The Belgian Government recently published a ruling granting a flat-rate tax deduction on patent licence fees (royalties).

The new system of taxing income from the use/licensing of patents is similar to the scheme recently introduced in the Netherlands, called the "Dutch Patent Box Scheme", and also to the 50 per cent reduction on royalty income in Hungary.

Enterprises will be able to deduct 80 per cent of royalties from patents licensed for use by a Belgian company or Belgian establishment of a foreign enterprise, to an associated company or third party, to the extent the income does not exceed an arm's length value.

For patents used internally by a Belgian company for the manufacture of its own patented products, the new rule provides for a tax deduction amounting to 80 per cent of the licence fee that the Belgian company would have received had

it licensed the patents used in the manufacturing process to an independent third party.

The new deduction will reduce the effective Belgian tax rate from 33.99 per cent to 6.798 per cent (i.e. 20 per cent of 33,99 per cent).

It will apply to all corporate taxpayers in Belgium, on income from the following new patents:

- Patents owned by a Belgian company as a result of its own patent-development activities in research and development centres in Belgium or abroad; and
- Patents acquired by a Belgian company from a third party, provided it has further developed the patents.

Dividends

The Belgian Government has also approved new rules concerning the taxation of dividends. Under the new system, dividends paid to non-resident shareholders by Belgian companies will be exempt from withholding tax provided the receiving company is resident in a country with which Belgium has signed a double tax agreement. This will allow non-EU taxpayers to benefit from exemption in the same way as European investors under the provisions of Directive 90/434/EC (the "Parent/Subsidiary" Directive).

HUNGARY

Tax exemption to include capital gains

The Hungarian Government has introduced some important amendments to its national laws on capital gains. The new rules, which came into force on 1 January 2007, make Hungary one of the most favourable jurisdictions for setting up a holding company.

Under the new system, no income tax or solidarity surtax will be levied on capital gains realised from the sale of a "qualifying" shareholding provided the partici-

pation has been held for at least two years prior to its sale.

A shareholding is classified as "qualifying" when it represents at least 30 per cent of the share capital of a Hungarian or foreign company (with the exception of controlled foreign companies - CFCs) and if the Hungarian tax authorities were notified of the acquisition within 30 days.

The exemption only applies to shareholdings acquired after 1 January 2007.

The absence of withholding tax on capital gains makes Hungary a particularly attractive location for Hungarian holding companies. Even before this latest measure was introduced all dividends deriving from shareholdings in Hungarian and foreign companies were tax exempt – regardless of the level of participation – and dividends, interest and royalties paid to non-residents attracted no withholding tax.

Some additional corrective measures have also been introduced to ensure that capital gains realised on mergers and divisions, transfers of assets and exchanges of shares are now tax exempt, in accordance with the so-called "Mergers Directive" (90/434/EEC).

Similar measures have also been introduced for calculating the taxable base for the solidarity surtax.

SWEDEN

Clarification of the holding regime

Sweden's tax authorities have clarified that the holding regime (participation exemption) also applies when the subsidiary is a legal entity deemed comparable to a Swedish enterprise regardless of the rate of income tax imposed by the country of residence of the subsidiary.

This ruling is important since the tax authorities consider the requirement to be met even in the case of subsidiaries resident in

Barbados, with International Business Company status and subject to an extremely low effective rate of income tax (approx. 2.5 per cent).

The contents of the ruling will have to be replicated in a ministerial resolution in order to become effective. However, the ruling provides useful indications that should be taken into consideration if using a Swedish company as a holding vehicle for investments in such jurisdictions, which are often excluded from participation exemption regimes.

ITALY

Amendments to the taxation of cross-border dividend, interest and royalty payments

New dividend taxation rules ("Parent-Subsidiary regime")

Legislative decree No. 49 of 6 February 2007 implements Directive 2003/123/EC of 22 December 2003, which in turn amended Directive 90/435 of 23 July 1990 (the "Parent-Subsidiary Directive") on the taxation of parent companies and their subsidiaries located in different EU Member States.

However, as far as incoming dividends (paid to an Italian company) are concerned, the amendments fall short of introducing some important and by now overdue changes to the current system.

Under existing rules (article 89 of the Italian Consolidated Tax Act - TUIR) dividends paid to Italian shareholders are 95 per cent exempt (there is no minimum shareholding requirement) as long as the distributing company is not resident in a black-listed country. Various aspects of this system stand out as being inconsistent with the principles of the EU legislation, especially with regard to the fact that (a) dividends distributed by EU companies resident in

Malta and Cyprus, which are still black-listed (despite the fact that they clearly fall within the scope of the “parent-subsidiary” Directive), and (b) dividends distributed by EU entities but “arising” from companies resident in “black-listed” countries are fully taxable.

These latest amendments, however, affect the taxation of outgoing dividends.

Point 1 of article 27-bis of presidential decree No. 600/1973 sets out the conditions that must be met in order for a parent company resident in another Member State to qualify for exemption from the 27 per cent tax withheld at source on profits distributed by a subsidiary resident in Italy.

The effect of the amendment will be to extend the exemption to income from other securities similar to shareholdings, such as shares, proceeds deriving from private partnership agreements and profit-sharing agreements and on excess loans according to the thin capitalization rules.

Other important amendments concern the minimum shareholding requirement and the conditions that must be met in order to benefit from exemption. Under the previous system, a parent company that directly owned at least 25 per cent of the share capital of the subsidiary distributing the profits qualified for exemption if it:

- a) took one of the forms listed in the Annex to Council Directive 90/435/EEC;
- b) was resident for tax purposes in an EU Member State;
- c) was subject to one of the taxes mentioned in the Annex to the aforesaid Directive in the country of residence without being exempt unless subject to local or temporal limitations;

d) had held the participation continuously for at least one year.

The minimum shareholding has now been reduced from 25 to 20 per cent of the share capital of the distributing company. Since the Directive should have been implemented as from 1 January 2005, the amendments came into effect retroactively as from 1 January 2005. Reimbursement requests can be filed with the tax authorities. Such requests must be filed within 48 months of the date on which the excess tax was withheld.

Said 20 per cent is reduced to 15 per cent for profits distributed after 1 January 2007 and 10 per cent for profits distributed after 1 January 2009.

As regards the tax residency requirement, the parent company must now be resident in a Member State of the EU and cannot be regarded as resident in a third (non-EU) state under the provisions of a tax agreement.

As a final consideration, the new law introduces stricter anti-avoidance rules (article 27-bis, para. 5). In particular the parent company can no longer be set up for the exclusive or principle purpose of benefiting from the exemption regime but must be established to “own the shareholding” in order to pursue the same goals. This circumstance is clearly much more difficult to prove.

New interest and royalties regime

Italy has complied with the indications of the European Commission concerning the correct implementation of Directive 2003/49/EC (the Interest and Royalties Directive). According to the Directive, interest and royalty payments between associated companies resident in different Member States may, under certain con-

ditions, be exempt from withholding tax. In article 3, para. 1, of legislative decree 143/05, which came into effect retroactively, the wording “interest and royalty payments accrued” has been amended and now reads “interest and royalty payments paid”.

Italy previously applied the provisions of the Directive to interest and royalty payments accrued on or after 1 January 2004 although the Directive only referred to the time at which said payments were received.

The aim was to “prevent fraud and tax evasion by foreign companies where payments of interest and royalties were intentionally delayed in order to benefit from the exemption” (circular letter 47/E of 2005).

The European Commission initiated an infringement procedure (2006/4136) against Italy. It pointed out that legislative decree 143 restricted the scope of application of the European Directive and considered the Italian provisions disproportionate.

By virtue of the amended law, withholding tax unduly levied on interest and royalties that became payable up to 31 December and was paid on or after 1 January 2004 pursuant to article 26-quater, para. 1, of presidential decree 600/73, will be reimbursed by the paying agent to the non-resident company.

The paying agent will reclaim the withholding tax from the Italian tax authorities through the compensation system in accordance with article 17 of legislative decree 241/97. The previous limit of 516,457 euro usually allowed for that purpose will not apply.