EU Tax News

July/August 2022 - issue nr. 5

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Germany – CJEU referral on trade tax addback of foreign portfolio dividends

By decision *I R 5/18* of 23 November 2021, the German Federal Fiscal Court referred the question to the CJEU whether the German trade tax addback of foreign portfolio dividends in 2001 is in line with the free movement of capital (Art. 63 TFEU).

The plaintiff, a life insurance company, is a German public law institution and subject to German corporate income tax (CIT) and trade tax (TT). In 2001, the plaintiff owned portfolio shares (each of them less than 10%) in several foreign companies and received dividends from the latter. In April 2004, the plaintiff exercised the so-called "block-option" which is applicable for life and health insurance companies. As a result of the application of this option, 20% of the portfolio dividends are not considered when determining the relevant profit for German CIT purposes. With reference to the German TT addback provision (sec. 8 no. 5 sent. 1 German TTA), the German tax office added back this tax-free 20% of the portfolio dividends received.

In an earlier decision dated 6 March 2013 (*I R 14/07*), the Federal Fiscal Court saw the TT addback provision (sec. 8 no. 5 German TTA), which applied to dividends from foreign shareholdings for the first time in the assessment period 2001, as a disadvantage for shareholdings in foreign companies, which violates Art. 63 TFEU, since no such addback was applicable for domestic dividends in 2001. Upon reconsideration the former decision appears doubtful to the Federal Fiscal Court as portfolio dividends were taken into account fully for domestic and foreign shareholdings in 2001 for German TT purposes, since the block option was also applicable for domestic shareholdings for the first time in the assessment period 2002 (i.e. domestic dividends were fully taxable at shareholder level in 2001 for CIT and TT purposes irrespective of the TT addback). The Federal Fiscal Court has, therefore, referred the matter to the CJEU.

The CJEU's case number is *C-258/22*.

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National Developments

Austria – Federal Fiscal Court decision on 'directive shopping'

The Austrian BFG (Court of First Instance) recently issued a decision on the application of the Parent Subsidiary Directive in a 'directive-shopping' case (BFG 3.3.2022, RV/4100351/2020, published in June). The shareholder structure on which the BFG proceedings were based was already the subject of a decision by the Austrian Administrative High Court (VwGH) in 2014 (VwGH 26.6.2014, 2011/15/0080-13), where the application of the Parent Subsidiary Directive on a profit distribution that was performed in 2008 was denied. Even though the taxpayer tried to increase the substance of the EU shareholders in the structure in the aftermath of the judgement of the VwGH (i.e., rental of office space, increase of number of directors), the BFG still rejected the application of the Parent Subsidiary Directive on the profit distributions performed in the period 2012-2017 in its recent decision.

An Austrian construction company (AT1-SE) distributed dividends in the period 2012-2017 to a Cypriot company (Ltd. 1; complainant), that held 25% plus one share in AT1-SE. The shares of Ltd. 1 were held by another company

resident in Cyprus (Ltd. 2). The shareholders of Ltd. 2 were – amongst others – companies resident in the Channel Islands and the British Virgin Islands, a natural person domiciled outside the EU and a Russian charitable foundation. The ultimate beneficial owner of Ltd. 1 was a Russian investor, which would be not entitled to the benefits of the Parent Subsidiary Directive.

Ltd. 1 requested refund of the Austrian withholding tax on the profit distributions in the period 2012 - 2017 based on the application of the Parent Subsidiary Directive. The complainant claimed that another Cyprus-based company (Ltd. 3; a sister company of Ltd. 1 and Ltd. 2) acted as a service company for Ltd. 1 and Ltd. 2, which was entrusted with all services in connection with the management of the investment in AT1-SE. Therefore, the complainant argued that it carried out sufficient economic activity in order to be eligible to the benefits of the Parent Subsidiary Directive. However, no written agreements in this regard were concluded and the claimed services were largely carried out free of charge so that no invoices evidencing these services could be provided. Due to a lack of appropriate evidence of the alleged services, the Austrian tax office rejected the refund applications, arguing that the interposition of the holding companies in Cyprus was abusive.

In the course of the complaint procedure, the Austrian BFG dealt with analyzing the following three questions in order to decide on the permissibility of the Parent Subsidiary Directive application in the case at hand (note: these criteria were derived based on previous VwGH and CJEU judgement (i.e. CJEU of 20.12.2017, Joint Cases *C-504/16 and C-613/16*, Deister and Juhler):

- Did the Cypriot companies (Ltd. 1, Ltd. 2, Ltd. 3) carry out an own economic activity?
- Were there any economic or other significant non-tax reasons for establishing the holding companies in Cyprus?
- Were the Cypriot companies (Ltd. 1, Ltd. 2, Ltd. 3) controlled by persons who would not be entitled to a withholding tax refund under the Parent Subsidiary Directive?

Economic activity:
According to the BFG neither Ltd. 1, Ltd. 2 nor Ltd. 3 performed an appropriate own economic activity. The alleged outsourcing of holding activities by Ltd. 1 and Ltd. 2 to Ltd. 3 could not be verified by the BFG due to the lack of written agreements concluded, processed, and documented in accordance with the arm's length principle. The BFG also pointed out that the governing bodies of Ltd. 1 did not attend the general meetings of AT1-SE (note: this task was performed by a Viennese lawyer).

Economic or non-tax reasons:
The BFG also rejected all economic and other non-tax reasons brought forward by Ltd. 1. These reasons comprised, among others, the need to establish a divisional holding company, ensuring more professional management by making it easier to (a) implement acquisitions of shareholdings, or (b) obtain approvals and financing in the EU area, and the lack of forwarding of the dividends to the shareholders of Ltd. 1 in the given structure (note: the dividends were accumulated at the level of Ltd. 1). Furthermore, the specific characteristics of Cyprus, such as the English legal language, a stable legal system and the availability of specialized local employees and consultants were not recognized by the BFG as significant non-tax reasons. Finally, the argument that Ltd. 1 acted as a joint venture since minor outside shareholders have been included in the shareholder structure (note: as shareholders of Ltd. 2) was rejected by the BFG. According to the BFG the participation of these 'outside' shareholders was purely tax driven since they acquired their shares in Ltd. 2 (FMV of these shares: approx. EUR 1 billion) for a purchase price of EUR 750.

Parent Subsidiary Directive entitlement of beneficial owners of the Cyprus companies:

Finally, the BFG concluded that due to the lack of economic activity of Ltd. 1, there is no doubt that it is controlled by the Russian investor respectively by persons and companies that would not have been entitled to a withholding tax refund on the basis of the Parent Subsidiary Directive in case they had held a direct investment in AT1-SE. Consequently, the BFG upheld the decision of the Austrian tax office to deny the withholding tax refund.

The decision of the Austrian BFG shows how important it is to have sufficient business substance in foreign EU-shareholders as well as to conclude written agreements in order to prove alleged activities performed by the foreign EU-shareholders. Otherwise, there is a significant risk that structures are considered as 'directive-shopping' with the effect that Austrian withholding tax cannot be refunded. An appeal against the BFG decision was filed by Ltd. 1 and the case is currently subject to proceedings in front of the VwGH.

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Hungary – CJEU referral on the Merger Directive

The case involves the taxation of a domestic demerger – that was a partial division – at shareholder level. One Hungarian company transferred a line of business to another already existing Hungarian company so arguably fitting into the definition of a partial division as detailed by the Merger Directive (2009/133/EEC). This transfer created a loss at the level of the shareholder that is also a Hungarian taxpayer. The loss was due to the fact that the shareholder derecognized the shares in the transferor company at fair value, while recognizing the new shares in the transferee company at book value of the business. This treatment was made possible under Hungarian Generally Accepted Accounting Principles (HU GAAP) that allows demerging using existing book values.

The Hungarian tax legislation implemented the Merger Directive in a way that losses at shareholder level are by default tax deductible, whereas gains are taxable with an option for deferral. These Hungarian rules do not distinguish between domestic and cross border mergers. Hungary also employs a participation exemption regime which basically exempts capital gains from taxation at shareholder level after a one-year holding period and treats any costs or expenditures in relation to the relevant shareholding (unless it is due to a transformation procedure) as non-deductible for tax purposes.

The Hungarian tax office claims that that the demerger triggered a tax liability at shareholder level:

- due to the fact the nominal (registered) equity of the transferor company was not reduced during the partial division; it contends therefore that the transaction cannot be treated as a transformation at shareholder level, and
- the relevant shares were covered by the Hungarian participation exemption regime; so losses on the shares are non-deductible,

irrespective that the transaction resulted in a loss at shareholder level.

The taxpayer on the other hand claims that the transaction should result in a tax-deductible loss at shareholder level or at least should not trigger taxation in line with the Merger Directive. The Hungarian court of first instance stayed proceedings and referred the following questions to the CJEU:

1. Whether the Merger Directive could apply to the relevant domestic demerger.
2. Whether the Merger Directive allows for taxation in a situation where the nominal capital of the transferor company did not change.

3. Whether the answer would be different where the transferor is a single shareholder company (i.e., where it is in substance indifferent to change the nominal and/or other capital elements during a transformation).

The CJEU's case number is *C-318/22*. It is yet to receive a hearing date and/or an AG (if any).

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Italy – Supreme Court rules withholding taxes levied on dividends distributed to German and US investment funds incompatible with EU law

On 6-7 July 2022, the Tax Section of the Italian Supreme Court ("Corte di Cassazione", the highest Court in Italy as regards tax matters) issued seven important judgments in which it ruled that Italian withholding taxes levied on dividends distributed to a German investment fund and six US investment funds are incompatible with EU law.

All the cases originate from different claims submitted to the Italian Tax Authorities by foreign investment funds (a German open-end investment fund and six US investment funds based in California) requesting the refund of the dividend withholding taxes suffered with respect to dividends received from Italian listed companies during the year 2003 (as regards the German investment fund) and the years 2007, 2008, 2009 and 2010 (as regards the US investment funds).

All the funds benefited from the reduced dividend withholding tax of 15% in accordance with the applicable double tax treaty into force between Italy and the respective foreign country concerned.

The requests for refund were based exclusively on EU law, in particular on the breach of Art. 63 TFEU (free movement of capital) by the Italian legislator to the extent the legislation provided - during the years at issue - for the application of dividend withholding tax at the rate of 27% in the case of non-resident investment funds (or the reduced double tax treaty rate, in the cases at issue, equal to 15%) whilst Italian investment funds were not subject to withholding tax and were only subject to a taxation of 12,5% - which could be reduced to 5% or 0% under specific circumstances - on the net income accrued in each tax period calculated based on the difference between the value of the fund's net assets at the end of each calendar year and the value of the net assets at the beginning of the same year, thus discriminating against foreign funds.

In the absence of replies from the Italian Tax Authorities, the investment funds filed several appeals before the Pescara Tax Court of First Instance which rejected all the appeals. The claimants appealed the negative judgments to the Pescara Tax Court of Appeal which also rejected all the appeals. In the end, the claimants appealed the cases to the Italian Supreme Court which instead upheld the claimant requests for refunds.

Supreme Court judgment related to the German investment fund

The Supreme Court Judges firstly acknowledged the absence of specific objections from the Italian Tax Authorities in the course of the litigation as regard the comparability from both a legal and regulatory standpoint between the German claimant – an open-end investment fund subject to the supervision of the German financial authority - and an Italian open-end investment fund. The fact that the claimant was fully owned by a German insurance company did not affect the comparability of the German fund with an Italian open-end investment fund – which under Italian law requires multiple investors - due to the fact the sole investor, being an institutional investor, was in any case representing a plurality of separate interests, collectively managed.

The Supreme Court Judges further highlighted that the application of the dividend withholding tax in the case of the non-resident German investment fund was solely due to the fact that the foreign investment fund was not resident in Italy but rather in Germany, highlighting that if the same type of investment was performed through the use of an Italian investment fund, such Italian investment fund vehicle would not have been subject to such taxation. Accordingly, the Supreme Court considered the difference of tax treatment as an unjustified infringement of Art. 63 TFEU ordering a full refund of the withholding tax suffered by the claimant.

Supreme Court judgments related to the US investment funds

The Supreme Court Judges, in their opening comment, highlighted that the Italian dividend taxation regime as regards foreign investment funds had already been scrutinised by the European Commission with specific reference to the discriminatory tax treatment of investment funds resident in the EU (EU PILOT 8105/15/TAXU) and this had eventually lead to the abolition of the dividend withholding tax for EU qualified investment funds (with effect only from 2021 onwards, see our previous newsalert here). The Judges acknowledged that notwithstanding the fact that the claimants were investment funds governed by US law and therefore not resident in a Member State of the EU, the principle of equal treatment enshrined in Art. 63 TFEU applies also as regards taxpayers who are residents in third countries, like the US.

Accordingly, making reference to the relevant jurisprudence of the CJEU on the discriminatory tax treatment of dividend withholding tax for foreign investment funds resident outside the EU (see *Emerging Markets*, *C-190/12*), the judges upheld the claimants' positions confirming that the difference of tax treatment between the claimants – subject to a final withholding tax of 15% - and a comparable Italian investment funds – only subject to taxation of 12,5% on the net income accrued – constituted an unjustified infringement of Art. 63 TFEU and, as requested by the claimants, ordered the refund of the withholding tax suffered equal to the difference between the rate of 15% and the rate of 12,5%.

These judgments from the Italian Supreme Court are of fundamental importance. The Italian Supreme Court is the highest Court in Italy with the specific role of ensuring the uniform interpretation of the law, including tax law provisions. The principle expressed by the Italian Supreme Court with these judgments regarding the discriminatory tax treatment suffered by foreign EU and non-EU investment funds in Italy on dividends received, although it is based on the Italian tax regime applicable until July 2011, is still relevant today. In fact, as from 1 July 2011, Italian investment funds are no longer subject to taxation at the rate of 12,5% on net income accrued (or the reduced rates if applicable) but exempt, thus putting Italian investment funds in an even better position – compared to foreign investment funds – than the one addressed in these cases. This was also recently acknowledged by the Pescara Tax Court of First instance (see our previous newsalert here).

The Italian Supreme Court, following the CJEU jurisprudence on the matter, also made clear that the principle of equal treatment as regard the taxation of cross-border dividends applies in favour of investment funds resident in third countries outside the EU granting adequate exchange of information. Moreover, the Supreme Court, as the Court of last instance with respect to litigation in Italy, is obliged to refer matters to the CJEU in any case where there is doubt concerning the interpretation of EU law. In the judgments under analysis the claimants asked the Italian Supreme Court - as an alternative request to the acceptance of the main application - to refer the matter to the CJEU. However, the Italian Supreme Court by upholding the claimants' main requests made clear that there was no need to refer the matter to the CJEU.

It is worth noting that the Italian lawmaker abolished the dividend withholding tax for qualified EU investment funds but only starting from 1 January 2021 and it did not extend the exemption to non-EU investment funds (see our previous newsalert here). The non exemption from the dividend withholding tax for qualified non-EU

investment funds (and for EU funds prior to 1 January 2021) is still contrary to EU law, as confirmed by the Italian Supreme Court with the judgments at hand. For this reason, both EU and non-EU investment funds should consider filing refund claims for the periods that are not yet statute barred (dividends paid from September 2018 onwards) in order to safeguard their rights to any refund

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Portugal – Notifications for recovery of Madeira Free Zone (ZFM) incompatible State aid

Following the European Commission decision (Commission Decision (EU) 2022/1414 of 4 December 2020) that concluded that Portugal unlawfully implemented the ZFM scheme in breach of Article 108(3) TFEU and that aid granted to individual beneficiaries under this scheme is incompatible with the internal market and must be recovered, a large number of companies established in ZFM have received notifications from the Portuguese Tax Authorities (PTA) aimed at recovering the underpaid tax due to the ZFM aid scheme.

The notifications are generally aligned with the European Commission decision and focus on:

- The origin of profits to which the reduced rate of taxation was applied, as the European Commission challenged it had been applied to profits generated from activities not effectively and materially performed in Madeira.
- The number and location of jobs considered (the benefits are linked to jobs created), as the European Commission challenged employment performed outside of Madeira and required that jobs were accounted as Full-time Employees (FTE).

There are several points open for discussion regarding the implementation of the European Commission focus points. Additionally, the PTA seem not to be safeguarding beneficiaries who received an advantage not exceeding the *de minimis* threshold of € 200.000. Portugal appealed against the European Commission Decision.

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Spain – New proposed Taxes on Banking and Energy sectors

On 28 July 2022, the Spanish political parties in the government proposed draft legislation that would impose temporary windfall taxes on banks and energy companies to raise EUR 7 billion over two years. The proposal calls for energy companies with EUR 1 billion or more in revenue in 2019 to pay a 1.2% windfall tax. Energy companies with less than 50% of its income coming from energy sales will be exempt. Banks with net interest income and fee revenues of at least EUR 800 million in 2019 would be liable for a 4.8% windfall tax.

These new taxes are estimated to provide more than EUR 2,000 million per year in collection in the case of the tax on energy companies, and EUR 1,500 million per year in the case of the tax to banks. The draft legislation also establishes that these taxes would not be deductible for Corporate Income Tax, and the proposal establishes a penalty of 150% of the amount if the companies and banks pass on the cost of the tax to customers and users. The proposal must be processed in the Congress of Deputies and if it is approved, the taxes would apply to 2023-2024.

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EU Developments

EU – European Commission launches public consultation on measures restricting the role of tax 'enablers' (advisors)

The European Commission launched on 6 July a public consultation on measures to address the role of "enablers that facilitate tax evasion and aggressive tax planning" in the European Union (Securing the Activity Framework of Enablers - SAFE). In short, the European Commission is asking for feedback on possible measures with regard to intermediaries that provide tax advisory services (the 'enablers') on complex structures that could lead to tax evasion or an aggressive tax structure. The options under consideration address the challenges linked to non-EU shell entities and include an obligation to adhere to an EU Code of Conduct; a requirement to undertake dedicated due diligence; and potential mandatory registration in the European Union. The consultation also raises questions about measures such as monetary penalties and loss of registration and addresses questions on taxpayers facing a new registration requirement for certain non-listed participations located outside the European Union.
See for more: PwC's Tax Policy Alert

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EU Fiscal State Aid Developments

Belgium – Approval of the amended Belgian tax shelter scheme to support the production of video games by the European Commission

On 25 July 2022, the European Commission approved the amended Belgian scheme to support the production of video games (Case SA.54817).

Since 2004, the so-called "tax shelter" has aimed to encourage the production and creation of European audiovisual works by granting them a tax incentive. This tax benefit is available for companies investing in the film's production provided certain conditions are fulfilled, notably a territorial spending requirement. In 2019, the Belgian legislator extended this scheme to video games with a cultural dimension under the same conditions, including the condition of spending in Belgium (Law of 29 March 2019 to extend the Tax Shelter to the video game industry). However, in 2020, the European Commission concluded, after a preliminary investigation, that the regime was neither in line with EU State aid rules nor with free movement of goods and services. The 2019 tax shelter for video games did not come into force.

The law of 5 July 2022 (published in the Official Gazette of 15 July 2022) provides for an amended tax shelter scheme for video games which includes changes to be compliant with EU law. This scheme sets out a tax benefit and an additional financial bonus for eligible video games producers. An eligible production company is a company whose main purpose and main activity is the production and development of video games. The tax benefit consists of an exemption of 421% of the amount invested, without exceeding certain limits and ceilings, and subject to actually obtaining a tax certificate. As a result of the legal changes, business expenditures on goods and services related to the video game production spent in the European Economic Area will qualify for the tax shelter (and not only those incurred in Belgium). In addition, the video game production must conform to a cultural standard/test as approved by the European Commission.

Besides these two amendments, the European Commission also found that the scheme is "necessary and appropriate to facilitate the development of cultural video games, thereby contributing to the promotion of

culture", proportionate and "will have a limited impact on competition and trade between Member states". Consequently, the European commission approved the amended Belgian tax shelter scheme. The approval runs until 31 December 2027.

The scheme will take effect from 1 January 2023.

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