Screening Exercise
Croatia and Turkey
Chapter 16 – Direct Taxation

Brussels, 6 June 2006

Unit E2 „Direct Tax Legislation“
DG Taxation and Customs Union (TAXUD)

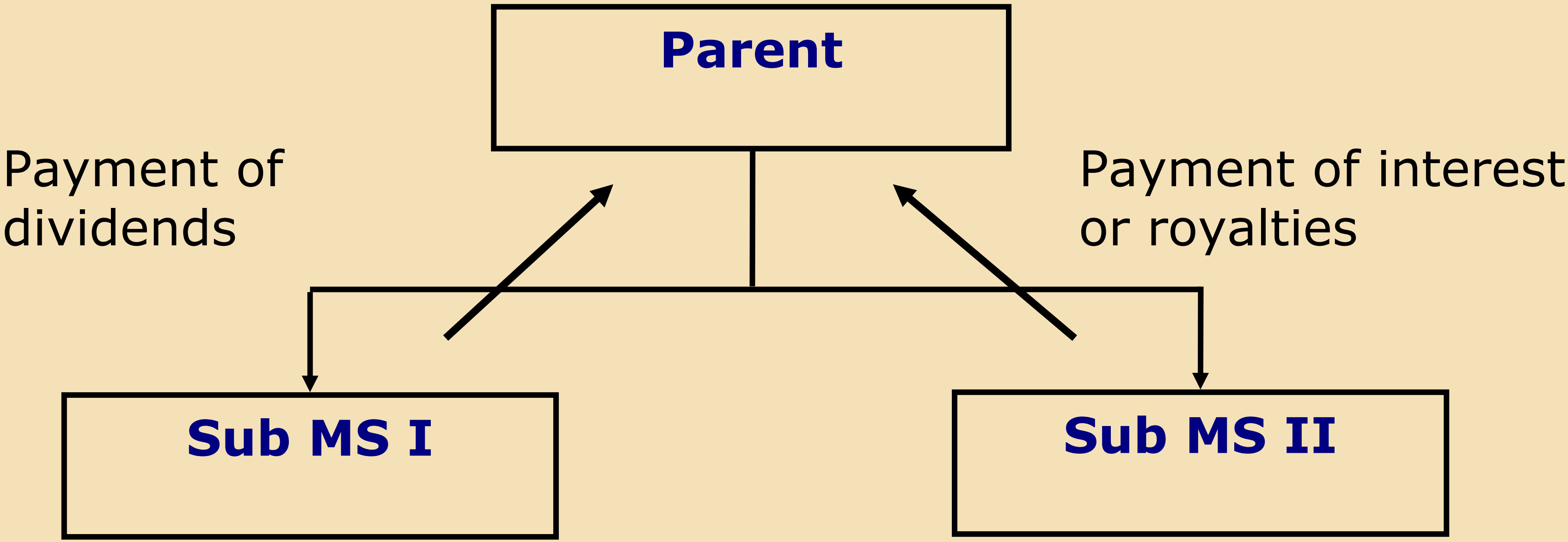
Introduction to the Community Acquis in Direct Taxation

Introduction

- **Legislative basis: Art. 94**

  "The Council shall, acting unanimously on a proposal from the Commission …, issue directives for the <u>approximation</u> of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the common Market"
- Compared with indirect taxation, only minor degree of harmonisation has taken place in direct taxation
- Major reason: **unanimity**

Concept for Business Taxation



Elimination of Distortions

- Elimination of distortions for cross-border economic activities for the formation of truly European Companies
- Objective: no obstacles, i.e. same treatment, to cross-border activities as internal ones.
  - <u>non-periodic</u> events, eg. Restructuring (deferral of taxation of hidden reserves)
  - <u>periodic</u> events:
    - Payment of dividends
    - Payment of interest
    - Payment of royalties
    - (taking into account of losses)

Results achieved or in progress

- **Elimination of distortions**
- **Tackling harmful tax competition**
  - Savings Tax Directive
  - Code of Conduct
- **Two-Track Strategy**
  - Targeted Measures
  - Comprehensive Approach (CCCTB)

Merger Directive

- **Council Directive of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States** (90/434/EEC) (OJ L 225, 20.8.1990, p. 1)
- **Council Directive 2005/19/EC of 17 February 2005 amending Directive 90/434/EEC on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States** (OJ L 58, 4.3.2005, p. 18)

Merger Directive I

- Council Directive 90/434/EEC of 23 July 1990 is intended to facilitate restructuring operations involving companies of different Member States in cases where such operations take the form of
  - Mergers
  - Divisions “Split-Up”
  - Partial Division “Split-Off” [Directive 2005/19/EC]
  - Transfers of assets
  - Exchange of shares
  - Transfer of registered office of SE/SCE [Dir. 2005/19/EC]

Merger Directive II

- Restructuring operations normally trigger the taxation of hidden reserves and therefore a tax payment without equivalent cash inflow from the realisation
- Practically in all Member States special rules provided for relief in domestic situations
- Merger Directive extends such relief by a common system to cross-border transactions and eliminates distortions by:
  - deferring taxation of hidden reserves,
  - safeguarding the financial interests of Member States

Operations covered by Directive I

- **Merger between companies:**

  definition based on 3rd Company Law Directive 78/855/EEC of 9 October 1978 on company law / reproduced in 10th Directive 2005/56/EC of 26.10.2005
- **Divisions of companies:**
  - Split-Up: definition based on 6th Company Law Directive 82/891/EEC of 17 December 1982; transferring company ceases to exist
  - Split-off: only one or more branches of activity are transferred in exchange of securities of the receiving company to the shareholders of the transferring company. Transferring company continues to exist.
- **Transfer of assets “Spin-off”:**
  - company which transfers is not dissolved
  - Transfer of all or one or more branches of activity to another company in exchange for the transfer of securities representing the capital of the receiving company

Operations covered by Directive II

- **Exchange of shares:**

  a company of a Member States acquires a holding in a company from another Member States such that it obtains a majority of the voting rights in exchange for issuing its own securities and if applicable, a small cash payments of the shareholders of the company whose securities are acquired.
- **Transfer of registered office of a SE/SCE**

  Accompanying tax measures regarding a transfer of registered office provided by Art. 8 of the statute of an SE and Art. 7 for an SCE.

Companies involved

Companies involved

- Companies from 2 or more Member States
- Definition of a “company of a Member State”:
  - Subject to corporate income tax as listed in Art. 3 lit c. without possibility of an option or of being exempt
    - List of taxes in Art. 3 lit. c
    - i.e. Directive does not extend to partnerships
  - Resident for tax purposes in a Member State
  - Legal form listed in annex

Ensuring Neutrality I

Art. 4 – Deferral of taxation on assets and liabilities

- Deferral (not exemption) until subsequent disposal of asset by receiving company
- Permanent establishment (pe) condition: assets and liabilities are effectively connected to a permanent establishment in MS of transferring company
- Receiving company takes over tax values of transferring company (book value roll-over)

Ensuring Neutrality II

Art. 5 – Carry-over of provisions and Reserves

- Permanent establishment “replacing” transferring company enters such reserves in its accounts,
- The permanent establishment assumes the rights and obligations of the transferring company
- Provisions are to be included in taxable income once they become irrelevant as a consequence of restructuring transaction

Ensuring Neutrality III

Art. 6 - Takeover of losses

- Loss carry-forwards of transferring company
- Are taken into account (roll-over) at level of receiving pe
- where such a relief is granted in purely domestic situations

Art. 7 – cancellation of holding

- Where receiving company already holds shares in receiving company, and those shares are cancelled as a result of a merger or division
- No taxation of such “cancellation” gains
- But: Member State may tax where holding does not exceed 25% (2005/06: 20 %; 2007/08 15%, from 2009 on: 10%.)

Deferral of Taxation of Shareholder I

Art. 8 – Allotment of new Securities to Shareholders when a Merger, Division or Exchange of Shares takes place

- The following may not give rise to any taxation:
  - Exchange of securities held by the shareholders of the absorbed company for securities of the absorbing company
  - Exchange of securities held by the shareholders of the divided company for securities of the companies receiving the assets of the divided company
  - In the case of an exchange of shares, the exchange of the securities transferred by the shareholders of the acquired company to the acquiring company in return for the latter’s securities

Deferral of Taxation of Shareholder II

Art. 8 cont'd

- taxation only deferred, provided that shareholder does not attribute a higher value to the shares received than the tax value of the shares transferred (book-value roll-over condition
- Any cash payment can be taxed immediately

Special Cases

Art. 9 – Transfer of assets

- Following articles apply to transfer of Assets:
  - Art. 4 (deferral of taxation on assets connected to a PE)
  - Art. 5 (carry-over of provisions and reserves) and
  - Art. 6 (takeover of losses)

Art. 10 – Special Cases

- Where a pe in a third Member States is (indirectly) involved in operation, the Member State in which pe is situated may not tax any hidden reserve

Anti-Abuse Provision

Art. 11 – Anti Abuse provisions

- If the operation has as its principal objective or as one of it s principal objectives tax evasion or tax avoidance, Member States may:
  - Refuse to apply the tax benefits laid down by the Directive, or
  - Withdraw the benefit
- Lack of a valid commercial reason
- But: ECJ interpretes anti-abuse rules strictly

Transfer of Registered Office

Deferral is granted under conditions similar to those applying to other operations covered by Directive

- Art. 10b: corresponds to Art. 4 – Deferral of taxation on assets and liabilities
- Art. 10c(1): corresponds to Art. 5 - Carry-over of provisions and Reserves
- Art. 10c(2): corresponds to Art. 6 - Takeover of losses
- Art. 10d: no taxation of shareholders for deemed “liquidation” gains

Transparent Entities

- Problem arises where difference in qualification:
  - Member State of residence: company is opaque
  - Member State of permanent establishment: company is transparent
- Provision that MS of permanent establishment has to grant book-value rollover, where this MS considers non-resident transferring entity as transparent

Parent-Subsidiary Directive

- **Council Directive of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States** (90/435/EEC) (OJ L 225, 20.8.1990, p. 6)
- **Council Directive 2003/123/EC of 22 December 2003 amending Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsiries of different Member States** (OJ L 7, 13.1.2004, p. 41)

Underlying Issues

- Minimisation of double taxation by, e.g. Double Taxation Agreements
- But: big differences between Member States:
  - Minimum threshold
  - Method for elimination of double taxation
- Foreign subsidiaries treated in a less favourable way and thereby distorting business decisions
- Conclusion: necessity for system for taxation of cross-border dividend flows between subsidiaries and parent companies similar to that in domestic situations

Rationale and Objective

Rationale:

3 layers of taxation in a cross-border parent-subsidiary situation

- Taxation level Nr. 1: Corporate income tax on the profits of the subsidiary
- Taxation level Nr. 2: Withholding tax charged on the distributed profits by the Member State of residence of the subsidiary
- Taxation level Nr. 3: Corporate Income tax on the profits of the parent company, which incorporates the profits distributed by subsidiary

Aim:

- Abolition of withholding taxes on dividend distributions
- Elimination of economic double taxation of profits of a subsidiary

Companies Involved

Companies involved

- Companies from 2 Member States
- Parent company has a participation of at least 25 % in the subsidiary
- Definition of a “company of a Member State”:
  - Subject to corporate income tax as listed in Art. 2 lit c. without possibility of an option or of being exempt
  - Resident for tax purposes in a Member State
  - Legal form listed in annex
  - Option: minimum holding period of at least 2 years
- Also applicable to Switzerland according to Art. 15 of the Savings Tax Agreement between the European Community and Switzerland!

Legal Consequences

- **Art. 4 – Elimination of Double taxation** by applying either
  - Exemption method, or
  - Credit method
- **Art. 5 – abolition of withholding tax** on dividend distributions
- **Transitional periods:**
  - New Member States: Estonia may apply withholding tax on dividend distributions until 31 December 2008 (Act of Accession)

Amending Directive 2003/123/EC I

Amending Directive 2003/123/EC:

- **Reduction of Threshold:**
  - 2005/2006: 20%
  - 2007/2008: 15%
  - 2009 -: 10%
- **Widening of scope:**
  - Update of list in annex, inclusion of SE and SCE
  - Application of directive to participations held by permanent establishment in another country (reaction of ECJ-case law)
  - Widening of scope of credit method to tax paid by subsidiary and any lower tier subsidiaries

Amending Directive 2003/123/EC II

- Treatment of transparent entities / conflicting qualifications
  - State of residence of subsidiary: opaque entity
  - But: state of residence of parent company treats subsidiary as transparent
    - Immediate taking into account of income of subsidiary
    - But: ensuring elimination of double taxation by applying exemption or credit method!
- Amendments entered into force on 1 January 2005

Interest and Royalties Directive

- **Council Directive 2003/49/EC of 3 June 2003 on the common system of taxation applicable to interest and royalty payments made between associated companies of different Member States** (OJ L 157, 26.6.2003, p. 49)
- **Council Directive 2004/66/EC of 26 April 2004 adapting ... Council Directives ... 2003/49/EC, in the fields of ... taxation, by reason of the accession of Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia** (OJ L 168, 1.5.2004, p. 35)
- **Council Directive 2004/76/EC of 29 April 2004 amending Directive 2003/49/EC as regards the possibility for certain Member States to apply transition al periods for the application of a common system of taxation to interest and royalty payments made between associated companies of different Member States** (OJ L 195, 2.6.2004, p. 33)

Objective and Scope of I+R-Directive

- Elimination of Distortions regarding interest and royalty payments between associated companies by
  - Eliminating withholding taxes
  - Avoidance of double taxation but ensuring that interest and royalty payments are taxed once in a Member State
- Only payments between directly associated companies; direct payment to grandparent company outside of scope
- Payments may also be received by permanent establishments of the associated companies

Companies Involved I

Art. 3 – Definition of a "company of a Member State":

- Subject to corporate income tax as listed in Art. 3 lit a (iii) without possibility of an option or of being exempt
- Resident for tax purposes in a Member State
- Legal form listed in annex
- Option: minimum holding period of at least 2 years

Art. 15 of Agreement between EC and CH

- Extension of provisions to Swiss companies

Companies Involved II

Art. 3 – Definition of "Associated Company"

- A company is an associated company of a second company, if at least
  - The first company has a direct minimum holding of 25% in the capital of the second
  - The second company has a direct minimum holding of 25% in the capital of the first
  - A third company has a direct minimum holding of 25% both in the capital of the first and second company.

Definition of Interest and Royalty I

- **Art. 2 – Definition of Interest (in principle as OECD Model Convention)**

  "Interest" means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from bonds and debentures, including premiums and prizes attaching to such bonds or debentures"

Definition of Interest and Royalty II

- **Art. 2 – Definition of Royalty (in principle as OECD Model Convention – additional text in bold)**

  "Royalties" means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic, scientific, work , including cinematograph films <u>and software</u>, any patent , trade mark, design or model, plan, secret formula or process, or for the use of or the right to use industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience; <u>payments for the use of, or the right to use, industrial, commercial or scientific equipment shall be regarded as royalties</u>."

Art. 6 - Transitional Rules I

- Beginning of Transitional period: linked to date of Application of Savings Tax Directive, i.e. 1. July 2005 (exception Slovakia: 1 May 2004)
- Applicable withholding tax rates limited to 10% for the first 4 years and 5% for the final years.
  - Lithuania and interest payments: 6 years 10%
  - Spain and Czech Republic for royalty payments: 6 years 10%
- Credit method

  Member State of recipient company have to credit the withholding taxes paid in the source state.

Art. 6 - Transitional Rules II

	Interest Payment	Royalty Payment
Czech Republic	--	6 years
Greece	8 years	8 years
Spain	--	6 years
Latvia	8 years	8 years
Lithuania	6 years	6 years
Poland	8 years	8 years
Portugal	8 years	8 years
Slovakia	--	2 years

Further Provisions

Art. 7 – Implementation

- Final date of implementation EU-15 = 01.01.2004
- EU-10 = 01.05.2004

Art. 9 – Delimitation clause

- The Directive shall not limit domestic or agreement based provisions designed to eliminate or mitigate double taxation of interest and royalties

Art. 5 – Fraud and Abuse

- Member States may, in the case of transactions for which the principal motive or one of the principal motives is tax evasion, tax avoidance or abuse, withdraw the benefits of this Directive or refuse to apply this Directive.

Future Steps

- COM(2003) 841: Proposal for an amending Directive still pending
  - Update of annex (e.g. at present SE and SCE not included!)
  - Stricter rules for Subject to tax clause

Savings Tax Directive

- **Council Directive 2003/48/EC of 3 June 2003 on taxation of savings in the form of interest payments** (OJ L 157, 26.6.2003, p. 38)
- **Council Directive 2004/66/EC of 26 April 2004 adapting … Council Directives … 2003/48/EC, in the fields of … taxation, by reason of the accession of Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia** (OJ L 168, 1.5.2004, p. 35)

The Need for Community Action

Underlying Issues of the Savings Tax Directive

- Fundamental Freedoms
- Principle of taxation of interest in country of residence
- Failure to declare foreign source interest
- Potential distortions in internal market

Aim of the Directive

- "… to enable savings income in the form of interest payments made in one Member State to beneficial owners who are individuals resident for tax purposes in another Member State to be made subject to effective taxation in accordance with the national laws of the latter Member State…"

Main Principles

Main Principles:

- Not tax harmonisation and full respect of existing international tax rules (allocation of taxing rights between source and residence, determination of fiscal residence …)
- The Directive only covers interest payments to individuals resident in other Member States
- Cooperation with key countries
  - Dependent /associated territories
  - Certain third countries

Definitions

Art. 2 – Beneficial Owner

- An individual who receives an interest payment
- Unless the recipient provides evidence that the interest payment was not received for his own benefit, or
- Unless the paying agent has reason to believe that the recipient is not the beneficial owner

Art. 3 – Identity and residence

- Minimum identification standards

Art. 4 – Paying Agent

- Economic operator
- Paying interest or securing the payment of interest
- For the immediate benefit of beneficial owner
- Some entities are given the role of Paying Agent at the moment when they receive an interest payment (see also Article 6.4)

Definitions

Art. 6 – Definition of Interest Payment

- Interest paid or credited to an account relating to “debt-claims of every kind”
- Interest accrued or capitalised at the sale, refund or redemption of the debt claims
- Income deriving from interest payments either directly or through an Art. 4 (2) entity distributed by UCITS or undertakings for collective investment established outside the EU
- Interest realised upon sale, refund or redemption of shares and units in UCITS and similar, if more than 40% of their assets are invested in debt claims

Definition of interest payment (II)

ECOFIN Conclusions on 12 April 2005:

- *"as regards interest accrued before 1 July 2005* that the Directive applies to all interest payments made from 1 July 2005 onwards, excluding the proportion of that interest which has accrued before that date.

- *as regards Article 6, paragraph 6 of the Directive:* that only income from undertakings for collective investment in transferable securities (UCITS) which invest directly or indirectly only 15% or less of their assets in debt claims can be excluded from the definition of interest payments set out in Article 6, paragraph 1 of the Directive."

Information Requirements

Art. 8 – Information reporting by Paying Agent

- Identity and residence of beneficial owner
- Name and address of paying agent
- Details of interest payment
- Account number or identification of the security

Art. 9 – Exchange of information

- Between competent authorities of Member States
- Automatic and without reciprocity requirement
- Within 6 months following end of tax year of Member State of paying agent
- Information is exchanged by means of a standard form agreed at Community level

Art. 10 - Transitional Period

- Applies only to Belgium, Luxembourg and Austria
- BE, LU and AT will receive information from other Member States
- Transitional period ends if and when:
  - Agreements are concluded with each of: Switzerland, Andorra, Liechtenstein, Monaco and San Marino providing for exchange of information on request as defined in the 2002 OECD Model agreement, in addition to the continued application of the withholding tax
  - Council agrees that US is committed to exchange of information on request as set out in the 2002 OECD Model Agreement

Withholding Tax

Art. 11 - Withholding Tax

- 15%: first 3 years (01.07.2005 – 30.06.2008)
- 20%: subsequent 3 years (01.07.2008 – 30.06.2011)
- 35%: thereafter (from 01.07.2011)

Art. 12 - Revenue Sharing

- 25% of revenue remains in Member State of paying agent
- 75% is transferred to Member State of the beneficial owner

Withholding Tax – Special Rules

Art. 13 - Exceptions to withholding tax

- BE, LU and AT to provide for authorisation and/or certificate procedure
- Authorisation (voluntary disclosure) covers all interest paid to beneficial owner by that paying agent
- Certificate issued by competent authority of Member State of residence of beneficial owner (valid for a period not exceeding 3 years) – Each Member State has to be prepared to issue such a Certificate within 2 months from request

Art. 14 – Elimination of Double Taxation

- MS of residence to ensure elimination of double taxation
- Existing withholding taxes are credited first
- If withholding tax exceeds amount of tax due, repayment
- Option: replacement of credit method by refund of withholding tax

Third Countries

- Switzerland, Andorra, Liechtenstein, Monaco, San Marino
- Basis for equivalent measures
  - Withholding tax with revenue sharing at same rates as BE, LU and AT
  - Exchange of information on request in cases of tax fraud or similar misbehaviour
  - Voluntary disclosure
  - Review Clause
- CH: Article 15 applies Parent-Subsidiary and Interest and Royalties Directives’ withholding tax exemption to Switzerland

Dependent or Associated Territories

- Same measures as Member States, i.e. automatic exchange of information or a withholding tax on same terms as BE, LU and AU
- Automatic exchange of information: Anguilla, Aruba, Cayman Islands, Montserrat
- Withholding tax: Jersey, Guernsey, Isle of Man, British Virgin Islands, Turks & Caicos Islands, Netherlands Antilles

Tasks before Accession

- Implement the Directive into national legislation
- Conclude bilateral agreements with dependent or associated territories
- Confirm to Switzerland, Liechtenstein, Andorra, Monaco and San Marino the political commitments taken within the Memorandums of Understanding
- Communicate to Council Secretary your competent authorities for the application of the Agreements with Switzerland, Liechtenstein, Monaco, Andorra and San Marino

Capital Duty Directive

- **Council Directive of 17 July 1969 concerning indirect taxes on the raising of capital (69/335/EEC)** (OJ L 249, 3.10.1969, p. 25)
- **Amending Council Directives:**
- **73/79/EEC and 73/80/EEC of 9 April 1973** (OJ L 103, 18.4.1973, p. 13)
- **74/553/EEC of 7 November 1974** (OJ L 303, 13.11.1974, p. 9)
- **85/303/EEC of 10 June 1985** (OJ L 156, 15.6.1985, p. 23)

Capital Duty Directive

- Council Directive 69/335/EEC of 17 July 1969 regulates the levying of indirect taxes on the raising of capital
- When adopted, the purpose of the Directive was to:
  - harmonise the taxes on the raising of capital, with regard to both their structures and rates; and
  - prevent Member States from creating or levying other similar taxes
- Capital duty is an indirect tax levied on contributions of capital for capital companies and restructuring operations involving capital companies

Amendments to the Directive

- The Directive was first amended by Directive 73/79/EEC and Directive 73/80/EEC of 9 April 1973 when the normal rate of capital duty was fixed at the level of 1% and the reduced rate, in respect of certain company reconstruction operations, was set out to be any rate between 0% and 0,5%
- The Directive was further amended by Directive 74/553/EEC of 7 November 1974, and lastly by Directive 85/303/EEC of 10 June 1985 when it was acknowledged that capital duty should be completely abolished, given its detrimental economic effects

Capital duty trend

- Following the last amendment to the Directive in 1985, Member States have the option to either exempt transactions or charge a single rate of tax not exceeding 1%
- Since 1985, the trend has been towards an elimination of capital duty and only 7 Member States (Greece, Spain, Cyprus, Luxembourg, Austria, Poland and Portugal) continue to levy it
- In Cyprus, capital duty is levied at a rate of 0,6%; in Poland the rate is 0,5%; and in Portugal the rate is 0,4%. In the remaining 4 Member States, the rate is 1,0%

Recast of the Directive

- A proposal for a recast (comprising a codification combined with certain amendments) of the Directive is currently in DRAFT, as part of the Commission simplification exercise
- The purpose of the recast is to:
  - simplify one of the most complicated pieces of Community legislation that exists;
  - abolish capital duty, which is a significant obstacle to the development of EU companies; and
  - reinforce the prohibition on the levying of other similar taxes

For any further information, please contact:

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