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CONTENTS

CJEU, EFTA Court Developments

National Developments

EU Developments

CJEU and EFTA Court Developments

Germany – CJEU Judgment on German withholding tax refund rules

In a Judgment dated 16 June 2022, on the ACC Silicones case (*C-572/20*), the CJEU ruled that the free movement of capital has been infringed by the German requirements for a withholding tax refund claimed by non-resident corporate taxpayers with regard to a portfolio shareholding.

The plaintiff, a UK company, owned 5.26% of the shares in a German company and received dividends in the years 2006-2008. The plaintiff claimed a withholding tax reduction from 15% (tax treaty level) to 0%. The Fiscal Court of Cologne asked the CJEU whether Germany's requirements for withholding tax refund claims filed by non-resident corporate taxpayers led to a breach of Art. 63 TFEU (free movement of capital). The first questionable condition requires that the German withholding tax was neither credited against taxes levied by the residence state of the shareholder or the residence state(s) of the latter company's direct or indirect shareholder(s), nor deducted as expense by any of said companies. Secondly, non-resident taxpayers must provide a certificate issued by the authorities of their residence state which proves that no credit or deduction was granted at the level of any direct or indirect shareholder.

The CJEU concluded that Art. 63 TFEU precludes the German requirements to achieve a refund of withholding tax. The requirements for withholding tax refund claims differ depending on whether the recipient of the dividends is a resident or a non-resident corporate taxpayer. The difference in treatment between resident and non-resident corporate taxpayers concerns objectively comparable situations as far as the risk of a double relief for withholding tax at any direct or indirect shareholder level is concerned. Therefore, in both cases the aim of preventing that withholding tax is credited twice must be pursued in a coherent and systematic manner and there is no reason to link the withholding tax refund in cross-border cases to stricter conditions than in domestic cases. The breach of Art. 63 TFEU cannot be ruled out based on the Double Tax Agreement (DTA) Germany-UK, because the UK credits German withholding tax only to the extent that the dividend is subject to UK tax. Moreover, the infringement of Art. 63 TFEU cannot be justified by overriding reasons in the public interest.

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Norway – EFTA Court rules combination of Norwegian interest limitation rules and group contribution rules incompatible with freedom of establishment

On 1 June 2022, the EFTA Court delivered its Judgment in the case of PRA Group Europe AS v the Norwegian Tax Authorities (*E-3/21*) concerning the lawfulness of the Norwegian interest limitation rules (as they read from 2014 to 2018) under the freedom of establishment in the EEA Agreement Article 31. The EFTA Court concluded that the combination of the Norwegian interest limitation rules and group contribution rules were in breach of the EEA Agreement as they enabled Norwegian companies having domestic group companies (common ownership of more than 90%) to lessen or remove the effects of the Norwegian interest limitation rules. This possibility was not available for Norwegian entities without domestic group companies.

PRA Group Europe AS was wholly owned by a Luxembourg resident parent and was partly funded through an interest-bearing loan from its Luxembourg parent. Deductions of interest on the loan had been partly denied under the Norwegian interest limitation rules (as they read in 2014 and 2015). The rules broadly limited deductions of net interest payments to group companies to 30% of a measure of the taxpayer's income (referred to in the case as tax EBITDA. The main issue raised for the EFTA Court was whether the denial of these interest deductions was in breach of the EEA Agreement, on the basis that taxable group contributions between Norwegian group companies might be used to increase a company's tax EBITDA, thereby lessening or removing the effects of the Norwegian interest limitation rules for companies having Norwegian group companies. As PRA Group Europe AS had no Norwegian group companies, the company had for its part been unable to utilise this possibility.

The Court first concluded that the Norwegian interest limitation rules, in combination with the group contribution rules, effectively place companies without Norwegian group companies at a disadvantage vis-à-vis companies that are able to utilise the Norwegian group contribution rules to lessen the effects of the interest limitation rules. In this respect, the Court noted that a potential restriction may result also from the interaction between two sets of rules (i.e. the interest limitation rules and the group contribution rules).

Second, the Court considered that a foreign EEA-based company in a group with a Norwegian-based company was in a comparable situation to that of a Norwegian resident company in a group with other Norwegian resident companies. With reference to *Lexel* (*C-484/19*), the Court held that a situation where a company established in one EEA State makes interest payments on a loan taken out from a group entity established in another EEA State is no different from a situation where the recipient of the interest payments is a group entity established in the same EEA State.

Lastly, the Court held that the restriction was not justifiable either on the basis of a balanced allocation of taxing rights between EEA States or for purposes of fighting tax avoidance. As Norway grants the benefit of a potentially increased interest deduction in the domestic situation (and thus renounces part of its taxation rights), it cannot argue that the same taxing right is important in the cross-border situation in an attempt to limit equal treatment of non-residents. Moreover, the rules at issue did not specifically target wholly artificial arrangements, nor did they provide the taxpayer with an opportunity to provide a commercial justification for such arrangements. The rules therefore appeared to go beyond what is necessary to attain the purpose of counteracting wholly artificial arrangements

The decision in PRA Group Europe AS cannot be considered particularly surprising in light of *Lexel*, where the CJEU had already settled that a combination of interest limitation rules and group contribution rules placing corporate taxpayers that are part of a domestic group at an advantage to corporate taxpayers that have no resident group companies would constitute a restriction under the EEA Agreement. Nonetheless, the EFTA Court's decision raises several questions, notably:

1. To what extent may Norwegian companies having only non-Norwegian group companies reclaim interest deductions denied between 2014 and 2018?
2. Does the decision entail that also the current Norwegian interest limitation rules (in effect as of 2019) are in breach of the EEA Agreement? The current rules contain an equity escape similar to the one set out in ATAD I Article 4 (although the directive is not directly applicable to Norway), which generally is available both to companies part of fully Norwegian groups and those part of cross-border groups. In effect, however, companies that are part of purely Norwegian groups will always qualify for the equity escape and obtain full interest deductions. The rules have already been the subject of complaints made to the EFTA Surveillance Authority.
3. Will the Norwegian authorities reassess and potentially amend the current Norwegian rules? One potential approach could be to limit the scope of the Norwegian equity escape clause for Norwegian corporate groups (rather than to extend it also to cross-border groups). It therefore remains to be seen whether the ultimate outcome will be beneficial or detrimental to taxpayers.

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Spain – CJEU rules Spanish legislation governing the state liability arising from the infringement of EU law contrary to the principle of effectiveness

On 28 June 2022, the CJEU issued its long-awaited Judgment in *Commission v. Spain* (case *C-278/20*). The CJEU partially upheld the action for non-compliance filed by the Commission against the Kingdom of Spain on the understanding that the regime of state liability for damages caused to individuals by legislative acts contrary to EU law is contrary to EU law itself. Even though it is not restricted to tax claims, the regulation also applies to requests for reparation of damages caused by taxes unduly paid.

The CJEU considers that part of the new Spanish regulations introduced by Laws 39/2015 and 40/2015 are contrary to the Principle of Effectiveness, specifically:

1) The requirement of a Judgment of the CJEU declaring non-compliance with EU law by the Member State is not compatible with the principle of effectiveness as, in accordance with its constant jurisprudence, the right to be compensated cannot be subject to the existence of a Judgment of the CJEU. As an indirect consequence of this, it is also considered contrary to EU law that the limitation period of one year is computed from the date of publication in the Official Journal of the European Union of the judgment declaring the infringement.
2) The requirement of having obtained a final judgment in any instance in an appeal against the administrative action is not admissible when the damage derives from an act or omission of the legislator without there being an administrative action that the individual can challenge.
3) The Spanish regulations which state that only damages produced in the five years prior to the date of publication of the CJEU ruling are compensable is contrary to EU law.

Spain is now obliged to amend its legislation in order to adapt it to the conclusions of the CJEU. Companies and individuals may consider filing claims for reparation of damages which were not admissible according to the regulations which have been declared in breach of EU law.

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UK – General Court dismisses both the UK and ITV plc's applications made in respect of the European Commission's UK Controlled Foreign Company State aid decision

On 8 June 2022, the General Court of the European Union dismissed both cases (*T-363/19* and *T-456/19*) in their entirety.

In April 2019, the European Commission announced that it had found the Group Financing Exemption (GFE) within the UK Controlled Foreign Company (CFC) rules to constitute unlawful State aid in certain circumstances.

The UK CFC rules are rules which broadly allow the UK to tax the income of overseas subsidiaries controlled by a UK corporate parent where that income is regarded as artificially diverted from the UK. The provisions in question, relating to the GFE, were introduced as part of the 2012 revision of the UK CFC rules and apply to offshore group financing arrangements with the result that, in certain circumstances, only 25% of the finance income is subject to a CFC charge (and in certain circumstances none at all).

The European Commission focused on the two ways in which the income might be regarded as related to the UK:

1) Where the loans are financed with funds or assets which derive from capital contributions from the UK

2) Where activities relevant to managing the financing operations are located in the UK

The European Commission considered that where the GFE provided an exemption for arrangements which fall into the first category above, this was justified since the exemption avoids a complex and burdensome intragroup tracing exercise. However, where the GFE had been applied to arrangements in the second category, the European Commission considered that the exemption was not justified and instead constituted unlawful State aid. The UK and a number of affected groups including ITV plc made applications to the General Court seeking to annul this decision. As a result of UK amendments effective from 1 January 2019, the European Commission decision is only relevant to periods up to 2018.

The General Court considered that the reference system was the CFC regime, rather than the UK corporation tax system as a whole. They concluded that the objective of the CFC regime was to tax profits which are regarded as having been artificially diverted from the UK. They further concluded that where any activities relevant to managing the financing activities are located in the UK, then the corresponding profits are, under the CFC rules, to be regarded as profits artificially diverted from the UK. As a result, they ruled in favour of the European Commission and agreed that companies applying the GFE benefited from a selective advantage (to the extent that the relevant activities took place in the UK). The Court also dismissed the arguments made regarding justification, concerning administrative simplicity and compliance with the fundamental freedoms.

It remains to be seen whether this decision is appealed to the CJEU. In the meantime, affected groups will also need to consider what further action if any to take regarding the ongoing domestic recovery proceedings.

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National Developments

Germany – Fiscal Court rules 5%-taxation of cross-border merger gains is compatible with EU Merger Directive

By decision *1 K 181/19* of 24 March 2022, the Fiscal Court of Schleswig-Holstein decided that the factual 5% taxation applicable with regard to a cross-border merger is in line with Art. 7 of the EU's Merger Directive.

The plaintiff is a German company which owned 100% of the shares in five companies with a seat or place of management in the EU. With effect from 1 April 2010, these entities were merged into the plaintiff. The assets were transferred at book values. Due to lower book values of the shares in the plaintiff's balance sheet, the mergers triggered a merger gain. The German tax office treated 5% of this gain as non-deductible operating expenses similar to a capital gain which would have been triggered in case of a sale of the shares. The plaintiff is of the opinion that the tax exemption of only 95% of the merger gain violates Art. 7 of the Merger Directive as this provision foresees that the full merger gain should be exempt.

The Fiscal Court explains in detail that the predominant opinion in tax literature assumes a violation of EU law, but nevertheless it agreed with the dissenting minority of authors. In the view of the Fiscal Court, the assumption of non-deductible expenses cannot be seen as a taxation of the merger gain. As the merger gain itself was still fully exempted under German domestic law the Fiscal Court refrained from referring the case to the CJEU but allowed an appeal against the judgment at the Federal Fiscal Court.

The appeal is pending at the Federal Fiscal Court under case no. *I R 17/22*.

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UK – Decision HMRC v Coal Staff Superannuation Scheme Trustees Ltd [2022] UKSC 10

On 27 April 2022, the UK Supreme Court allowed an appeal by HMRC in the *Coal Staff Superannuation Scheme* case – determining that the UK regime for taxation of 'manufactured overseas dividends' does not entail any restriction on the free movement of capital under Art.63 TFEU. The Supreme Court is the UK's final appellate court. The case raised a novel issue regarding compatibility of the UK rules with Art.63 TFEU. Had this arisen for determination prior to Brexit, the Supreme Court would have been obliged to refer the issue to the CJEU under Art.267 TFEU, third indent (Case *C-283/81*, *CILFIT,* para 11). Under s.6(1)(b) of the European Union (Withdrawal) Act 2018, however, no further reference to the CJEU by a UK court is permitted after 31 December 2020, and so the Supreme Court had to determine the issue itself.

The case relates to the taxation, in periods up to 2013, of manufactured overseas dividends received under stock lending agreements by a tax-exempt pension fund. Manufactured dividends ('MDs') and manufactured overseas dividends ('MODs') are contractual payments due under (inter alia) stock lending agreements relating to, respectively, UK and non-UK shares or securities. The contractual payment is designed to preserve for the stock lender the same income benefit as the dividend which it would have derived from the shares if it had not lent them.

The pre-2014 tax regime was designed to achieve the same tax result for the stock lender as if it had received the actual dividend on the shares. In the case of MDs (in relation to UK shares), the pension fund enjoyed exemption (as an exempt fund). In the case of MODs (in relation to non-UK shares), however, the regime required the stock borrower to withhold UK tax equal to the foreign withholding tax that would have been due on the actual dividend. The pension fund argued that this tax – which was UK tax, not foreign tax – entailed a difference in treatment (compared to MDs) which was an unlawful restriction on the free movement of capital.

The Court noted first that there was in any event a disincentive for an exempt pension scheme to invest in non-UK shares as compared with UK shares. Actual dividends on UK shares were exempt. Dividends on non-UK shares would suffer foreign withholding tax, which the pension scheme could not recover. However, this was juridical double taxation resulting from the absence of harmonisation of national tax systems, which did not entail any breach of Art.63: Case *C-436/08* *Haribo*, paras 167-172.

Therefore, the special tax regime for MODs would not breach Art.63 TFEU unless it created a disincentive to the acquisition of foreign shares (as compared with UK shares) additional to that which arose already from the juridical double taxation of actual dividends. There was clearly no direct additional disincentive, as the UK withholding tax suffered on the MODs was the same amount as the foreign withholding tax which would have been due on actual dividends. Whether there was an indirect additional disincentive depended on whether the stock borrower's obligation to account for the UK withholding tax was likely to have reduced the amount it was prepared to pay the stock lender (the pension fund) by way of stock lending fee. There was no evidence about this; but HMRC put forward unchallenged evidence that the stock borrowers would typically have more than enough withholding tax credits available to soak up the withholding tax liability by way of set-off, and that those tax credits were otherwise unavailable for use for any economically beneficial purpose. On that basis it was unlikely that the MOD withholding tax would have reduced the amount the stock borrower was prepared to pay by way of stock lending fee. Hence it was no more than speculation whether the MODs tax regime added to the existing disincentive for tax-exempt investors to acquire foreign rather than UK shares, constituted by juridical double taxation. Such speculation fell short of the logical inferences which the court might draw under the Art.63 case law. Therefore, the MODs tax regime did not entail any restriction on the free movement of capital contrary to Art.63.

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EU Developments

EU – European Commission issues proposal for Directive regarding a debt-equity bias reduction allowance (DEBRA) and a limitation of the tax deductibility of exceeding borrowing costs

On 11 May 2022, the European Commission published an EU Directive proposal regarding a debt-equity bias reduction allowance (DEBRA) and a limitation of the tax deductibility of exceeding borrowing costs. The proposal is a key element of the European Commission's Communication on Business Taxation for the 21st Century. The proposal aims to address the disparity in treatment between debt and equity financing by introducing a tax-deductible allowance for equity investments over a 10-year period, as well as further limiting the ability to deduct interest on debt investments. The restriction on deducting debt interest will interact with the existing interest limitation rule (ILR) under Article 4 of the Anti-Tax Avoidance Directive (ATAD). The proposed rules would apply to taxpayers that are subject to corporate income tax in one or more EU Member States, including permanent establishments of non-EU head offices. The proposed rules do not apply to financial undertakings (as exclusively defined in the proposal). EU Member States that already apply an allowance on equity under their national law may postpone application of the rules for a period up to 10 years and in no case for a period longer than the duration of the benefit under national law. See for more details and analysis on the propsal here.

As part of a newly established joint Secretary-General-DG TAXUD procedure, the European Commission also opened a public consultation for interested parties to provide feedback on the European Commission's adopted proposal, until 8 July 2022.

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EU – European Parliament and Council reach political agreement on European Commission proposal addressing distortions caused by foreign subsidies

After a period of negotiations, on 30 June the Council of the European Union and the European Parliament reached political agreement on the text of a draft regulation on foreign subsidies that, in certain cases, are distorting the internal market (see also our previous tax policy alert on the initial proposal). This proposal aims to ensure a level playing field in the internal market. This draft regulation is an important next step that follows the Commission's publication of a White Paper on distortive subsidies in June 2020. The White Paper set out several approaches to address distortive effects caused by foreign subsidies. The proposal is part of the broader EU 2020 industrial strategy driven by the principle of 'enhancing strategic autonomy.'

See for more details PwC's Tax Policy Bulletin *here*.

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EU – European Commission publishes Annual Report on Taxation 2022 and Taxation Trends in Member States, starts series of "EU tax mix on the road to 2050" events

On 28 June 2022, the European Commission published its Annual Report on Taxation 2022 , which according to the European Commission highlights that EU Member States' tax revenue has decreased for the first time since the 2009 financial crisis, while public expenditure jumped from 46.5% in 2019 to 53% in 2020 due to the COVID-19 crisis, and concludes that the pandemic and Russia's invasion of Ukraine are testing both the resilience of EU economies and the EU's capacity to respond. The 2022 report was published together with an accompanying report on Taxation Trends in Member States over the last years.

The publication of the Annual Report also marked the start of a series of events to help steer the discussion towards an EU tax framework that is fit for the future. As such an online European Commission event with EU Economy Commissioner Gentiloni and other high-level speakers discussed "Mega-trends and the impact on Taxation" and “the changes needed to make taxation more resilient and better performing over the long term”.

As per the European Commission’s press release: “This series of events will culminate in a high-level Tax Symposium on 28 November 2022 on the "EU tax mix on the road to 2050". The Symposium will generate input and ideas on the large-scale changes needed in taxation across the EU and will orientate the European Commission's policy priorities for the future."

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ABOUT THE EUDTG

EUDTG is PwC's pan-European network of EU law experts. We specialise in all areas of direct tax, including the fundamental freedoms, EU directives and State aid rules. You will be only too well aware that EU direct tax law is moving quickly, and it's difficult to keep up, but it is crucial that taxpayers with an EU/EEA presence understand the impact.

See for more info: www.pwc.com/eudtg or contact bob.vandermade@pwc.com