Tax Planning International

European Tax Service

Volume 12, Number 9 – September 2010

INTERNATIONAL INFORMATION FOR INTERNATIONAL BUSINESS

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TAX PLANNING INTERNATIONAL EUROPEAN TAX SERVICE is published by BNA International Inc., 38 Threadneedle Street, London, EC2R 8AY, England. Telephone: (+44) (0)207 847 5801 for subscription enquiries. Fax: (+44) (0)207 847 5840. E-mail: marketing@bnai.com. Subscription prices: U.K. mailing addresses and rest of the world £965; Euro zone €1,585; U.S. Canada U.S. $1,645. Back issues available on request. Additional copies of this publication are available to existing subscribers at half price when they are sent in the same envelope as a standard subscription.

www.bnai.com *ISSN 1754-1646*

From the Editor

The global financial crisis has been a much visited and debated topic but the stark reality is that we cannot safely say whether we have emerged out of it. Such has been the intensity of the impact that most countries today have shifted their focus on cutting their enormous levels of public debt to manageable proportions. **Fox Caspar** opens this issue with his detailed comparative narrative on 28 countries' deficit levels and their individual measures adopted to reduce them.

Next, **Michiel Beudeker** discusses the concept of 'Hybrid' entities in the Netherlands and the specific provisions included thereon in the 2008 Netherlands – UK tax treaty followed by **Denis-Emmanuel Philippe** and **Peter Vlietinck** , who present comprehensive information in their article on income tax and VAT issues affecting " international non-profit institutions", being very commonly established entities in Belgium.

France brings interesting development as **Claire Guionnet Moalic** and **Clarisse Sand**, in their article discuss the impact of the recent termination of the tax treaty between France and Denmark on incomes received from one Member State by tax entities resident in the other Member State.

Next, **Frank van Kuijk** outlines the impact of the termination of the H1929 regime in Luxembourg by which all H1929 companies are set to lose their tax exempt status by December 31, 2010 followed by latest updates from Lithuania by **Valters Gencs.**

The *In brief* this month brings important announcements from Germany, Latvia and Lithuania and from the *ECJ* , we bring you news on preliminary questions regarding real estate transfer tax on share deals referred by the Spanish Supreme Court to the European Court.

Last but not the least, in the *VAT*, **Volker Jorczyk** looks at the controversial proposed introduction of the so-called "bed tax" (*Bettensteuer*), in the German state of North Rhine-Westphalia (NRW), on hotel overnight stays in the city, which has received full support from the Cologne City Council.

Any suggestions or any articles or news reports can be sent by email at jdialani@bna.com or by telephone at +44 (0) 20 78475807.

Dialani

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International public debt review: a comparison of 28 countries

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As most countries reeling under the impact of one of the worst global economic downturns, try to surge ahead on the recovery path, their priority has shifted towards bringing down the extremely high levels of public debt. This article is an indepth analysis of the current debt levels of 28 countries throwing light on the measures taken by the respective governments to shrink their deficits.

Caspar Fox is a tax partner in the London office of international law firm, Eversheds LLP and heads its Corporate Tax Practice.

I. Background

As the global economy recovers from its worst recession since the Second World War, the financial markets have shifted their focus to the high levels of public debt in many countries across the world.

These high levels of debt are clearly unsustainable. The question is when they should start being reduced, at what rate and using what measures. This is a difficult balancing act for governments: they do not want to risk undermining their country's economic recovery or indeed their own political position, but they equally have to ensure that they do enough to appease the nervous financial markets.

This review considers the current levels of public debt in 28 countries, assessing what measures their governments are taking to reduce their budget deficit levels and how much headway they are likely to have made in reducing them by 2013.

II. Summary

Of the countries reviewed, those in the EU need to reduce their debt levels on the most urgent basis (although there are a couple of honourable exceptions). Those governments have woken up to their fiscal predicament, with many now regarding cutting their budget deficit as their key priority.

However, the concern is that their plans will be derailed by economic or political factors. There is worrying evidence of this occurring among those who have already been on an austerity drive for a while. Those EU countries which successfully implement the painful measures required to tackle their debt levels, on the other hand, look set to be burdened with an extended period of sluggish economic performance. The threat of the Japanese experience of economic stagnation since the early 1990s, or even a return to recession, looms large.

The picture is much healthier in the reviewed countries outside Europe. The most affected have sufficient breathing space to be able to reduce their budget deficits gradually, thereby lowering the risk of harming their economic prospects. For the others, the absence of high levels of unsustainable public debt means that they can continue to invest from a position of strength. They are therefore better placed to take advantage of future growth opportunities.

There are notable differences between the approaches being taken by governments to tackle their debt levels. Some have been on an austerity drive for the last couple of years, while others are only now starting on theirs. Several are seeking to spread the austerity measures (and the associated pain) over a few years, but others have decided to front-load many of the measures. In addition, some governments seem

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to be at risk of relying on over-optimistic levels of future economic growth to meet their deficit-cutting targets.

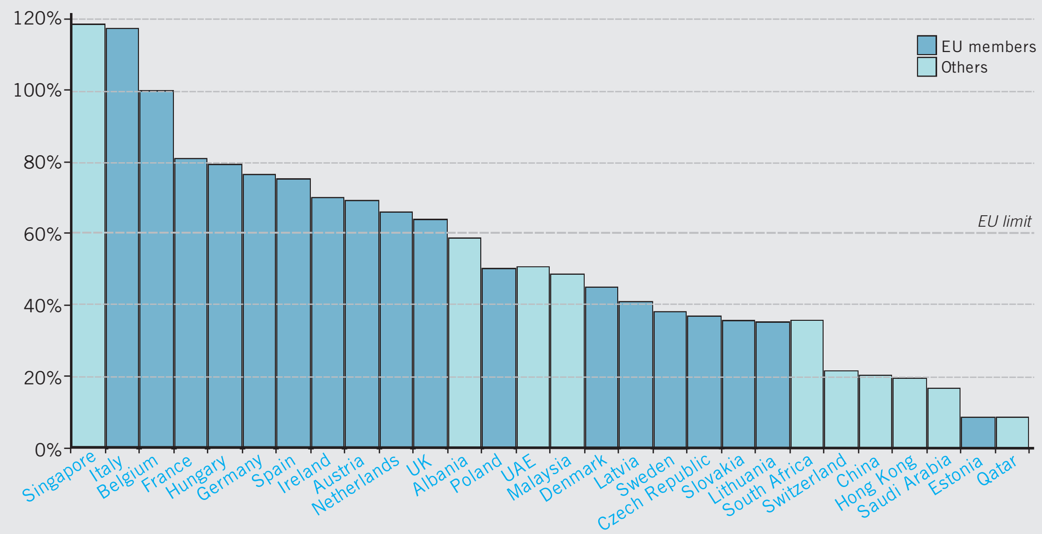
However, there are also some clear trends from the various governments' deficit-cutting measures. Spending cuts have recently been used much more widely than tax hikes, and this looks set to continue over the next year. Indeed, several countries have used tax cuts in the past year to boost the economic growth of their private sectors, with corporation tax cuts being the favoured tool. VAT has been the most popular tax to increase, since it is generally regarded as the least growth-impeding tax - and an increase generates significant extra tax revenues. In addition, many countries are unsurprisingly focusing on ensuring that they collect a greater share of the tax which they believe should be paid, for example by reducing the black economy or clamping down on tax evasion.

What lessons can be learned from the review's findings? The main one is that all countries should adopt a robust constitutional debt brake, to prevent them from suffering precarious public debt levels in the future.

The EU currently has a constitutional debt brake in the form of caps on the permitted public debt and budget deficit levels of its members, but needs to be strengthened and enforced rigorously. In the meantime, member states should consider following Germany's lead in unilaterally introducing a debt brake.

III. Current levels of public debt

Chart 1: Current public debt (as % of GDP)



A high level of public debt is only a problem when the country needs to tap the financial markets to fund that debt; and those markets begin to lose confidence in the government's ability to service it and so, charge a higher price for providing the funding. The countries with the three highest levels of public debt in Chart 1 (Singapore, Italy and Belgium) have high personal savings rates. This enables their governments to finance much of their debt from domestic savings, which reduces their reliance on the external financial markets. Singapore is an extreme example of this: it has not borrowed externally for over 20 years.

The market' confidence in the EU member states (and particularly those within the euro zone) slumped earlier this year, which resulted in the May bail-out of Greece by the EU and IMF. Many of the established European economies had been at fault by failing to use the earlier boom times to reduce their public debt levels, so their debt burdens were already significant at the start of the recession. As they then introduced economic stimulus packages, those debt levels rose to worrying heights - and are continuing to rise. The EU requires its member states to have public debt levels of no more than 60 percent of GDP, but the level for the whole of the EU currently exceeds 75 percent.

Aside from the UAE (which is burdened by Dubai's debt crisis), the public debt levels in the Middle East are unsurprisingly low, given the high oil prices in the boom years. China and Hong Kong also have sustainable levels of public debt, helped by their projected high rates of future economic growth. The figure for China does not take account of the worrying explosion of local government borrowing over recent years, however, which raises the prospect of significant bad debt for the country's banks and so may cause issues for the Chinese central government in the future.

Besides the actual levels of public debt, the markets are understandably concerned about their expected future trajectory - will the levels be going up or down, and at what rate? Where a government borrows to finance its budget deficit in any particular year, the level of public debt rises by that amount. Chart 2 on the following page shows the current public debt and annual budget deficit levels of each country and is therefore a better reflection of the countries' relative financial position.

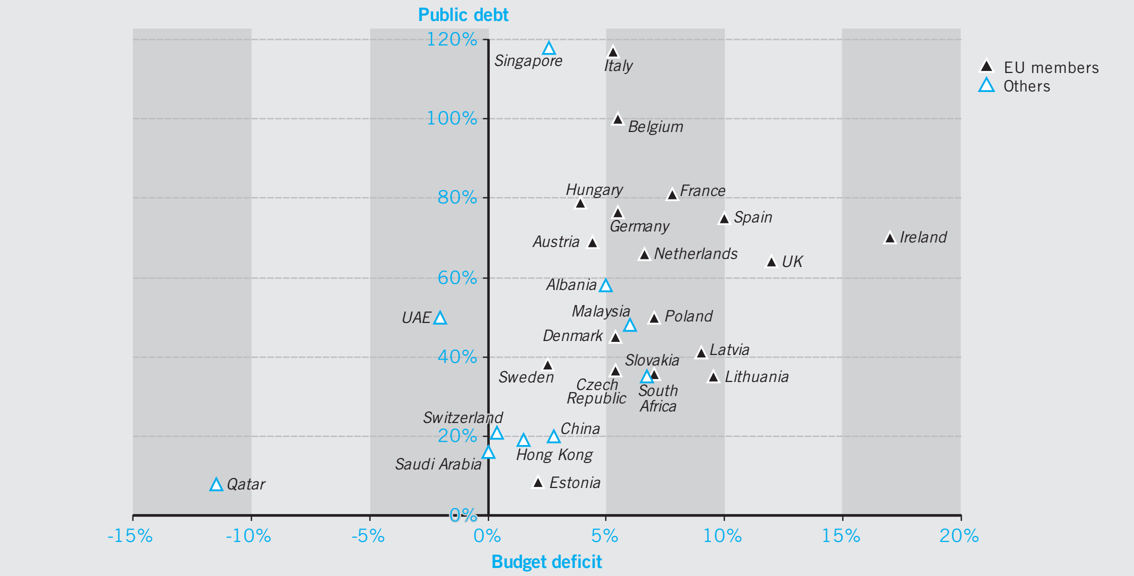
IV. Current budget deficit levels

Once budget deficit levels are taken into account, Ireland stands out from the crowd. Its high current budget deficit of around 17 percent of GDP is even more worrying given the large amount of fiscal consolidation which its government has carried out so far, although the deficit figure has been temporarily inflated by some recent bailouts of its banks. Nevertheless, the relative success of its recent bond auction shows that the Irish government is currently winning its battle to convince the financial markets of its sincerity in tackling its debt situation head-on.

Interestingly, only two of the reviewed member states currently satisfy the EU rule of having a budgetary deficit of no more than 3 percent of GDP: Estonia and Sweden. Estonia's finances have been kept under tight control, to ensure that it will be accepted as a euro zone member in January 2011. Sweden therefore provides a better lesson for other member states.

Sweden adopted a conservative fiscal policy in the previous extended period of economic growth, so it had a budget surplus heading into the global crisis. This stability has allowed the government to run only moderate budget deficits to fund its ambitious economic stimulus plan during the recession, and these tax cuts and welfare programmes have helped to buoy domestic demand in its economy. Because of its sound finances, Sweden is not under pressure to reduce its government spending in ways that could hinder the

Chart 2: Budget deficit vs public debt (as % of GDP)

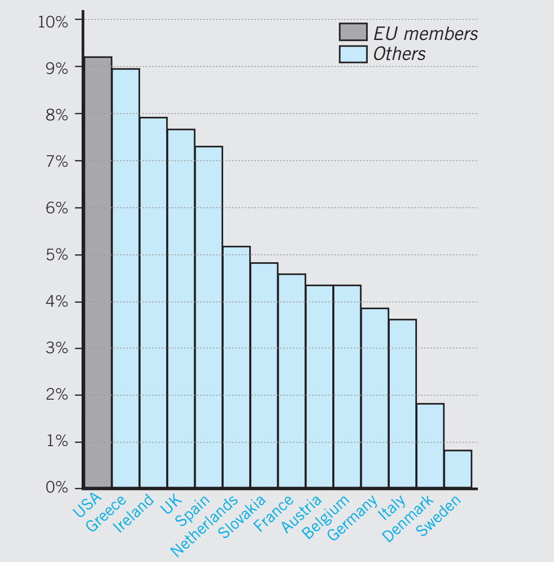


sustainable growth of its economy. Its economic prudence enabled the previous ruling coalition to win the most votes in this month's political elections (albeit not a majority).

The sound fiscal performance of Switzerland is also notable. It can be largely attributed to the country's constitutional requirement that, although the government may run annual deficits, public revenue and expenses must balance over an entire economic cycle. This debt brake helped Switzerland rein in its spending and build up buffers for the recession.

Budget deficits comprise of structural and cyclical elements. While the cyclical portion will be corrected by the country's economy returning to growth, the structural portion results from a fundamental imbalance in the government receipts and expenses. The structural deficit therefore indicates what needs to be tackled through tax and spending measures.

Chart 3:
Estimated structural budget deficit for 2010



Source: IMF World Economic Outlook Database, April 2010

Based on the IMF's estimates for the structural deficits of some selected countries in 2010, Chart 3 above shows that Ireland has the highest projected structural deficit of the countries reviewed for this report, with the UK and Spain following close behind. To put this into perspective, Greece has required a significant bail-out from the EU and IMF and its projected structural deficit is not much larger. The surprise statistic is that the USA heads the table, and yet the US Federal Reserve has recently decided to continue its economic stimulus programme. Is the USA relying on the premise that it is too big to fail?

The size of the economy is certainly a factor. Although Chart 2 may suggest that Hungary and Latvia are financially better placed than Spain or the UK, these two emerging economies have already been bailed out by the EU and IMF earlier in this recession.

Outside Europe, those countries with budget deficits are under less market pressure. South Africa's previous fiscal conservatism, for example, has given it sufficient breathing space to cut its deficit gradually over the medium term, allowing it to continue to promote economic growth through tax cuts and spending support in the meantime. Hong Kong and Singapore currently have small budget deficits, but these are cyclical in nature.

Even more healthily, the Middle Eastern economies of Qatar, Saudi Arabia and the UAE do not have a budget deficit and so can continue to invest heavily in their economic futures. The one blemish is Dubai, which continues to weigh down the overall performance of the UAE.

V. Projected budget deficit levels for 2013

All of the reviewed EU member states have committed to reduce their budget deficits to meet precise targets over the next few years. Many of these targets are to satisfy the EU limit of 3 percent of GDP in 2013, if not before then. In addition, in June this year the G20 leaders pledged to halve their budget deficits by 2013.

These commitments have been required to quell market concern. But are they likely to be honoured? Chart 4 on the next page shows projections for the budget deficit levels of the reviewed countries in 2013. This chart reveals that, of the 18 EU member states reviewed, only half of them are expected to have budget deficit levels in 2013 which satisfy the 3 percent limit.

A. Malaysia

For some countries, there is a danger that their government will say what the markets want to hear but then will not be politically willing and able to adopt the painful measures needed to meet the targets. In Malaysia, for example, investors are growing increasingly sceptical that the current government will push through the proposed economic reforms, due to opposition from ethnic Malays (who form its core support base).

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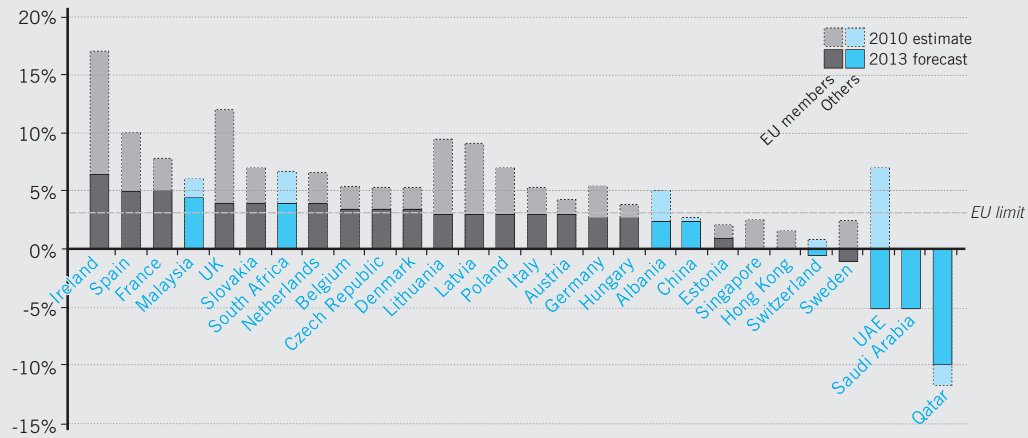
Chart 4: 2010 and 2013 budget deficits (as % of GDP)



B. Belgium and the Netherlands

The delay in forming coalition governments in Belgium and the Netherlands, and the prospect of future political instability caused by differences between the various coalition partners, is also likely to affect their ability to achieve their targets.

C. France and Spain

In addition, there is a concern that some governments are being unrealistic in how they can meet their targets. For example, France's plans remain vague (in stark contrast to Germany and the UK) and are at risk of relying on over-optimistic levels of future economic growth. Spain also seems dependent on high rates of economic growth to cut the deficit in line with its targets.

D. Ireland

Some countries are expected to miss their targets, however, through no fault of their own. The most relevant example is Ireland, which has won praise from investors for pushing through sharp austerity measures earlier than most and is expected to continue to take painful actions to reduce its budget deficit. However, there is a real concern that those actions could act as a major drag on the country's economic recovery and even perhaps cause it to slide back into recession, posing a significant threat to its plans to meet the EU target of 3 percent of GDP by the end of 2014.

E. UK

Since coming into power earlier this year, the UK coalition government has taken decisive action to tackle its deficit. Only a month after its formation, for example, it outlined tax changes and spending plans for the next five years. The need for compromise to keep both coalition partners happy makes it unlikely that sufficient measures will be taken to enable it to meet its ambitious aim to eliminate its structural budget deficit within five years, but it is expected to make significant in-roads into the deficit by 2013. However, the legacy is likely to be an extended period of sluggish economic growth with weak domestic demand.

F. Hungary

Hungary acts as a warning for others now considering how quickly to reduce their deficits. It was in an austerity-induced slump in 2007, even before the global downturn, and since being rescued from insolvency by the EU and IMF in 2008 it has been forced to renegotiate budget targets with them because it found that the spending cuts and tax hikes pushed its economy into much deeper recession than expected. The resulting economic crisis caused the previous government to lose in the elections this spring, and the new government appears determined to seek to stimulate the economy even if that costs it the support of the IMF and EU. Hungary is expected to miss the target set by the EU of reducing its deficit to 3 percent of GDP in 2011, but it should still be reaching that figure by 2013. Nevertheless, this will have been achieved at huge economic and political cost, and it will still have a worryingly high level of public debt.

G. Latvia and Lithuania

Latvia and Lithuania have also suffered deep recessions, with staggering drops in GDP of 18 percent and 15 percent respectively last year. As a result, the significant spending cuts which they have made in the past have had little impact on their deficit-to-GDP ratios. Latvia's reliance on the IMF and Lithuania's eagerness to achieve euro adoption should mean that both countries will take all measures required to reach the 3 percent EU limit by 2013 - which in Lithuania's case the government is hoping will be achieved by increasing revenues from the state-owned enterprises through an efficiency drive, rather than by needing to introduce further painful austerity measures.

H. Middle East

Outside Europe, the picture is still projected to be much rosier. In particular, the reviewed countries in the Middle East are expected to experience significant budget surpluses in 2013 courtesy of the global economic recovery boosting oil and gas prices.

VI. Deficit-cutting measures

The two main ways for a government to cut its budget deficit are for it to reduce its expenditure or to increase its tax revenues (by either increasing its tax rates or extending its tax base). The IMF recommends that fiscal consolidations be dominated by spending cuts (typically to the tune of 80 percent compared to only 20 percent for tax increases). Historically, however, tax increases have been a more favoured way of reducing deficits.

Charts 5 and 6 on the next page show that most of those reviewed countries which are adopting budget-cutting measures have been relying much more on spending cuts recently and look set to do so over the next year. Austria has announced that 60 percent of its fiscal consolidation will be achieved from spending cuts and 40 percent from increased tax revenues, for example, while the UK is envisaging a 77 percent: 23 percent split. Part of this weighting towards spending cuts is likely to be caused by the urgency of the need for countries to be reducing their deficits, because there is a considerable time lag before tax increases flow through into greater tax revenues. Another contributing factor is that many of the reviewed countries already have relatively high tax burdens.

Chart 5: Weighting of tax and spending measures over the past year

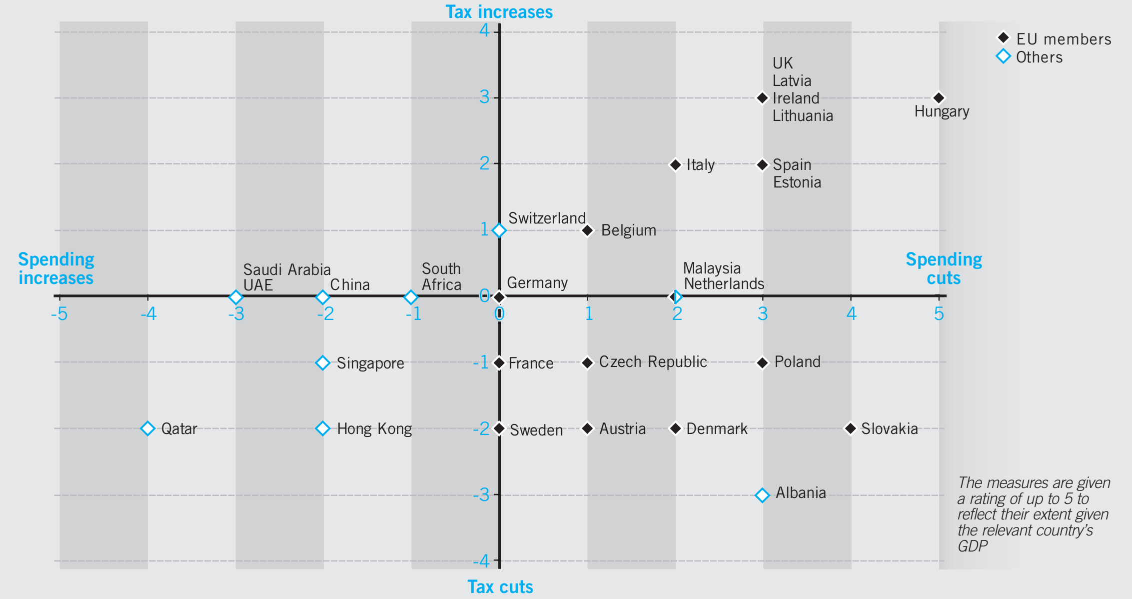
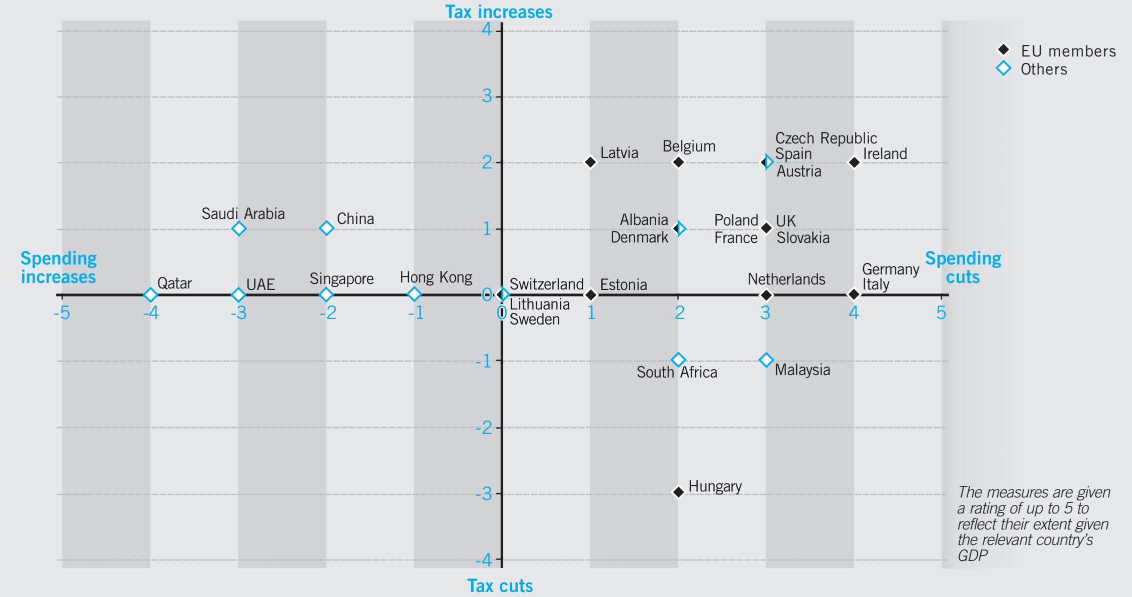


Chart 6: Weighting of expected tax and spending measures over the next year



Charts 5 and 6 above also show that many countries are at different stages of introducing their budget-cutting measures. The likes of Austria, France and Germany have only recently moved from taking measures to stimulate their economies to focusing sharply on reducing their deficits, whereas Hungary, Ireland, Latvia and Lithuania started their austerity drives before the period covered by the review.

Not surprisingly, many of those countries with middling deficits (such as Belgium, Denmark, the Netherlands, Malaysia and South Africa) appear to be seeking to reduce them in a gradual, measured way, since they seem to have the luxury to do so.

Two countries in Eastern Europe with middling deficits are proposing to introduce significant measures over the next year to tackle their deficits, however, even though their debt levels remain well below Western European levels. The government in Poland is anxious to prevent its public debt exceeding 55 percent of GDP, as this would automatically trigger painful spending cuts which would be likely to hurt public support for it. The government has therefore confirmed a cap on discretionary spending and further privatisation, and it envisages a 1 percent rise in VAT from 2011. While there is no constitutional debt brake in the Czech Republic forcing its hand, the government there is similarly seeking to show that it has not lost control of public debt (which has been rising quickly in recent years). France is seeking to spread its measures and the associated pain over a few years, in contrast to the UK's more front-loaded approach. Both governments are looking for the perfect balance between introducing austerity measures which restore the markets' faith in their public finances without pushing their economies back into recession or causing them to lose political power. Although the French approach may in theory produce the better result economically, the concern is that it is more at risk from dwindling political stamina for austerity in the future as elections loom.

Outside Europe, Qatar, Saudi Arabia and the UAE look set to expand their public expenditure programmes as they seek to diversify their economies away from dependence on natural resources. China, Hong Kong and Singapore will also continue to make significant public investments.

VII. Last year's tax measures

Chart 7 above shows which of the main categories of tax had either their rate or their scope increased or decreased over the last year in the 28 reviewed countries, and by what extent.

TPETS ISSN 1754-1646

Chart 7: Tax measures over the past year, by category

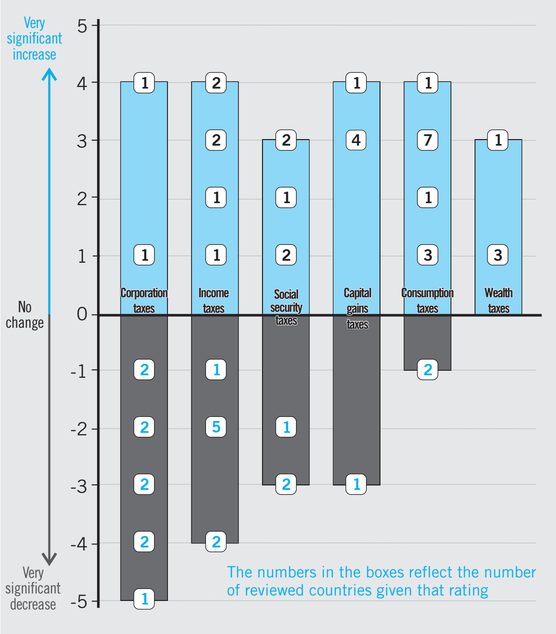
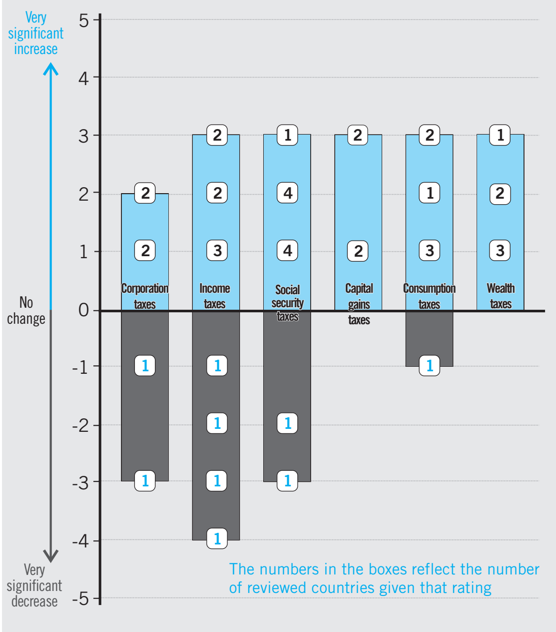


Chart 8:
Tax measures expected over the next year, by category



The most striking feature is the number of countries which reduced the corporation tax burden last year. Even for the one country (Hungary) which materially increased its corporation tax rates in that period, some of this increase looks set to be reversed soon.

These corporation tax reductions have been driven by the desire to attract foreign investment and stimulate the domestic economy. Many governments (such as the UK) view a reduction in corporation tax charges as a good way of boosting the private sector at a time when tough measures are being taken to scale back the public sector. For example, Qatar has cut its corporate tax rate to a flat rate of 10 percent as part of its initiative to attract foreign investment to produce a hi-tech, service-based economy which is not dependent on the oil and gas sectors. Despite the pressure to deliver a strong austerity drive, Ireland appears to regard its low corporation tax rate as sacrosanct. Similarly, the government of Slovakia has pledged not to increase its flat rate of corporate tax.

The other noteworthy trend is that several countries have increased their consumption tax (i.e. VAT) rates over the last year. OECD research suggests that consumption tax is the least growth-impeding tax, and its broad base means that a rise in its rate generates significant additional tax revenues. Several governments (such as Slovakia, Spain and the UK) have therefore decided that this is the least bad tax to raise - despite the charge that it is a regressive tax.

Chart 7 shows a mixed picture for income and social security taxes. Several countries have reduced the burden of one or both of them over the past year, while others have implemented increases during the same period. This reflects the differing financial positions and policy approaches of the countries reviewed. Sweden has been able to reduce its income tax burden significantly over the past year from a position of strength, for example, whereas the likes of Ireland, Lithuania and the UK have raised their income and social security tax charges as part of their austerity measures.

VIII. Next year's tax measures

Chart 8 above looks at the next year, gauging the extent to which the reviewed countries are expected to be introducing tax measures. Unsurprisingly, fewer tax cuts are expected, as their economies recover from recession and governments focus on cutting their deficits. A notable exception is Hungary, which is intending to reduce its corporate and personal income tax rates because its new government believes that the economy needs to be stimulated after 3 years of austerity.

Some countries (such as Poland) are expected to raise their consumption taxes in the near future. Beyond the next year (and so not covered by this review), it also seems likely that a VAT system will be introduced in Malaysia and across the Gulf Cooperation Council (which includes, among others, Qatar, Saudi Arabia and the UAE) - to reduce the dependence of their government revenues on oil and gas prices.

Capital gains and wealth taxes are taxes on the rich, and so increases in them are still likely to be used in the next year to ensure that the rich take their appropriate share of the pain. China is focused on ensuring that the gap between the rich and the poor does not pose a threat to the country's social harmony, and rumours are circulating that it will introduce a social security tax and trial a wealth tax (in some areas) in an effort to restrict this widening gap.

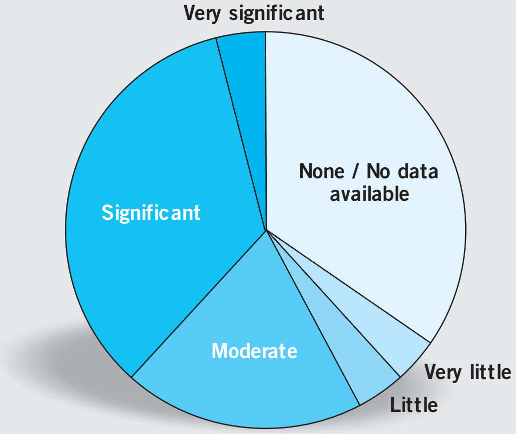
Not shown on Charts 7 and 8 is a new and very topical type of tax. Taxes specifically on banks or bankers' bonuses are being introduced by some EU countries (such as France, Germany and the UK). In addition, the EU is considering the possibility of a tax by its member states on financial transactions. Although the G20 leaders could not recently agree on a proposal for a global bank or financial transactions tax, several countries are likely to introduce taxes to ensure that the financial sector makes a "fair and substantial" contribution to the cost of the economic crisis. However, countries will need to ensure that these taxes are not so large as to cause banks simply to relocate to countries which do not impose a tax. There is concern that the large bank tax recently imposed in Hungary, for instance, could prompt foreign banks to scale back their Hungarian operations.

IX. Reducing the tax gap

Other than raising tax rates or extending the tax base, a further way for governments to increase their tax revenues is by reducing the "tax gap" in their country. There is no single definition of what constitutes the tax gap, but essentially it represents the amount of total tax which should be collected but is not. It covers a broad spectrum of matters, including tax evasion, fraud and the black economy (also known as the shadow economy).

Few countries have carried out a detailed study of the size of their tax gap. The tax gap in the UK is

Chart 9: Extent of recent measures being taken to reduce the tax gap



Very little	Estonia
Little	Austria
Moderate	China, Germany, Lithuania, Poland, Spain
Significant	Albania, Belgium, Denmark, Ireland, Italy, Latvia, South Africa, Sweden, UK
Very significant	France

approximately 8 percent of the total tax which should be collected, and it is likely to be considerably higher in many other countries. For instance, Latvia estimates that its shadow economy accounts for 20-30 percent of its GDP, while a recent study suggests that the amount of income unreported by China's households equates to approximately 30 percent of the country's GDP.

Given the need to cut budget deficits at a time when tax revenues are low but tax rates are already high, several countries in Europe have not surprisingly been focusing on reducing their tax gaps (see Chart 9 above) - especially as a crackdown on tax evaders is a popular message with the electorate and arguably a political requirement in the current pressured times.

Countries are taking varying approaches to tackle their tax gaps. Concerted attempts are being made in Denmark and Latvia to reduce their black economies, and Albania has required all payments for goods and services to be registered with their tax authorities unless made through a bank. Tax amnesties are proving a popular tool, with Italy leading the way, while France, Ireland and the UK are taking serious measures to close down tax loopholes which exist in their legislation. However, reducing the tax gap is easier said than done - as shown by the recent revelation that the UK's tax gap rose by GBP 4 billion last year.

As part of its drive to ensure that the widening gap between rich and poor does not cause social unrest, China is expected to enforce more thoroughly the requirement that wealthy individuals must report their income directly to the tax authorities each year. The recent push by several countries to reduce their tax gaps has also impacted on low-tax jurisdictions such as Switzerland and Singapore, who have been coerced into helping other countries to fight cross-border tax evasion.

Hungary plans to begin phasing in a flat 16 percent tax rate on personal income at the beginning of 2011, which will significantly reduce the rate of tax paid by higher earners. Based on experiences elsewhere (such as in Slovakia), this is expected to lower the level of tax evasion and may actually lead to higher tax revenues.

X. Final thoughts: lessons to be learned

The recent global economic crisis has served as a painful reminder of the power of the financial markets. The immediate focus of countries has been to restore the markets' confidence in their economies. This has resulted in them taking action beyond the austerity measures discussed in this report. For example, the Abu Dhabi government is setting up a debt management office to give investors greater transparency on the data for making informed decisions on investing in its debt.

The crisis has also reinforced the need for several countries to reduce the reliance of their government revenues on oil and gas prices. The Malaysian government remains committed to introducing a goods and services tax, which would make it less dependent on payments by the national oil company (which currently supply more than 40 percent of government revenues). The introduction of a VAT system across the whole of the Gulf Cooperation Council is also being seriously considered, to meet the need for governments in that region to diversify their revenue tools.

The most important lesson that countries can learn from the crisis is to adopt a robust constitutional debt brake, to prevent them from suffering precarious public debt levels in the future. While the recent proliferation of international budget watchdogs such as the UK's Office for Budget Responsibility is a step in the right direction, it is not the full solution. The role of these watchdogs is to check that their governments' fiscal forecasts stand up to scrutiny, whereas many countries are needing a mechanism which ensures that over time their governments lower the public debt to acceptable levels and maintain those debt levels within prudent parameters going forward. Some countries have already recognised this: Germany introduced a debt brake last year which requires its structural budget deficit to be capped at 0.35 percent of GDP in 2016, while the government of Saudi Arabia has announced that it will not consider tapping the debt market until it has lowered its public debt below 10 percent of GDP.

Of the countries reviewed, Switzerland seems to have had the most effective debt brake at the outset of the recent crisis. The Swiss government is allowed to run annual budget deficits, but it must balance its revenue and expenses over an entire economic cycle. By removing much discretionary spending power from the politicians, this debt brake has helped Switzerland to build buffers for the recession and therefore be well placed for the economic recovery.

In contrast, the current EU rules on public debt and budget deficit levels are less restrictive and are essentially toothless. The sanctions are not tough, and they do not apply to member states which have not adopted the euro and, despite regular breaches, have never been enforced against euro zone members. These rules need to be strengthened and enforced rigorously, so that breaches of them result in more than mere political embarrassment. This debate has begun recently, but member states should consider following Germany's lead in unilaterally introducing a debt brake of their own in the meantime.

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Hybrid entities and the 2008 Netherlands - UK tax treaty

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In the ensuing article, the author looks at the so-called 'Hybrid' entities and the specific provisions included thereon in the 2008 Netherlands – UK tax treaty.

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I. Introduction

A. Status

In 2008, the Netherlands and the United Kingdom signed a new comprehensive tax treaty and protocol ("Treaty"), which – upon entry into force – will replace the current tax treaty signed in 1980 as amended by the 1983 and 1989 protocols ("Current Treaty"). The entry into force of the Treaty is dependent on the ratification procedure in the Netherlands, where the UK already ratified the Treaty in February 2009. It is expected that the Treaty will be further discussed in Dutch parliament in September 2010, but it is uncertain whether ratification will take place before year-end 2010, in order for the Treaty to come into force as per 2011. Where ratification only takes place in 2011, entry into force will be as from 2012. Further reference is made to a previous publication on the Treaty.

B. Overview

Article 22 of the Treaty contains specific provisions with respect to hybrid entities; an entity which is considered opaque in one state and tax transparent in the other state. The Dutch explanatory notes to the Treaty ("Explanatory Notes") provide further guidance by means of examples hereon, whereas the UK parliamentary proceedings did not specifically address these provisions. It should be noted that the Current Treaty does not contain provisions as regards to hybrid entities.

This article, in Part II, will firstly address hybrid entities from a Dutch and UK tax perspective. In Part III, the provisions in Article 22 of the Treaty as well as the specific examples provided thereon in the Explanatory Notes will be addressed, followed by concluding remarks in Part IV.

II. Hybrid entities

A. General

In line with the OECD Model Tax Convention, Article 1 of the Treaty depicts that the Treaty shall only apply to 'persons' who are 'residents' in either the Netherlands and/or the UK. Hence, this generates two questions in determining the application of the Treaty to an entity:

- Is the entity a 'person'; and
- Is the entity a 'resident' in either the Netherlands and/or the UK?

To that effect, Article 4 of the Treaty depicts that a 'resident' is any 'person' (which is defined in Article 3), who under the laws of that state is liable to tax.

In view of the above, situations may arise in which an entity is considered a body corporate and liable to tax according to the domestic tax laws of one state (e.g., the Netherlands) and as transparent (and therefore not liable to tax) according to the domestic tax laws of the other state (e.g., the UK), or vice versa. Such entities are therefore considered hybrid.

In this example, the UK would for tax purposes disregard the entity, and would instead tax the participants on their share of the entity's income and would not consider the entity a 'resident'. From a Dutch tax perspective however, the entity would be considered opaque meaning the entity itself is taxed on its income and would thus consider the entity to be 'resident'. These differences in classification of an entity ("Classification Conflicts"), may lead to double (non) taxation and raises questions as to entitlement to tax treaty benefits. In other words, the question arises who can benefit from the Treaty: the entity itself or its participants? This is, however, only one example in which Classification Conflicts may result in double (non) taxation.

B. OECD Report

In 1999, the OECD issued a report (The Application of the OECD Model Tax Convention to Partnerships –

"OECD Report") addressing Classification Conflicts and focusing on specific factual examples. Recommendations for dealing with the international taxation of partnerships (i.e., hybrid entities) in practice were also presented therein. These recommendations were subsequently also included in the Commentary to the OECD Model Tax Convention. The Netherlands endorsed the principles of the OECD Report, but did express certain reservations as the OECD Report does not provide for a comprehensive solution in respect of Classification Conflicts and therefore wishes to deal with these conflicts separately in tax treaties.[1] To that effect, solutions for Classification Conflicts have been provided for in Article 22, paragraphs 2 through 5 of the Treaty.

It should be noted that the Netherlands has also included similar provisions in its current applicable tax treaties with the US, Belgium, Indonesia and Barbados and its tax treaties (which are not yet in force) with Hong Kong, Japan, Switzerland and Oman. For purposes of this article, I will only briefly address the provisions in the current applicable Netherlands – US tax treaty ("US Treaty") as these are very similar to the provisions included in the Treaty.

The provisions in Article 22 will be further addressed in part III. Beforehand, the general treatment of hybrid entities from a Dutch and UK tax perspective will be addressed; firstly, two commonly implemented Dutch entities which may be considered hybrid and secondly how foreign entities are classified from a Dutch tax perspective. The same approach will be followed from a UK perspective. Subsequently, Classification Conflicts that may arise in a Dutch/UK context will be addressed.

C. Hybrid entities from a Dutch tax perspective

1. Dutch entities

The most commonly known and implemented Dutch entities which may be considered hybrid are the limited partnership (*commanditaire vennootschap* – "CV") and the fund for joint account (*fonds voor gemene rekening* – "FGR"). Albeit that both the CV and the FGR can either be transparent or opaque from a Dutch tax perspective, they may be considered differently and thus hybrid from a non-Dutch perspective.

The CV is a limited partnership having no legal personality (albeit that a legislative bill is pending that allows election for legal personality), between at least one general partner having unlimited liability and at least one limited partner being liable to the amount of its capital contribution. For Dutch corporation and dividend tax purposes, the CV can either be transparent (referred to as 'closed') or opaque (referred to as 'open'). The distinctive criterion is whether the accession or substitution of limited partners requires the consent of all (limited and general) partners. Where this is not the case, the CV is considered open/opaque. If the accession and the substitution do require the prior consent of all partners, the CV is considered closed/transparent ("Consent Requirement"). A deemed consent applies for partners in the CV, if such consent is requested and not expressly declined within four weeks after the date of the request.[2]

The FGR is comparable to a mutual fund, has no legal personality and is established by entering into a co-ownership agreement between the custodian, the administrator and the participants. The custodian is, for the expense and risk of the participants, the legal owner of the assets of the FGR and the administrator performs the management services. The liability of the participants is typically limited to the amount of their contributions and commitments to the FGR. Similar to the CV, the FGR can either be transparent/closed or opaque/open. The decisive criterion is also the Consent Requirement, which differs however from the CV. Participations can (opposed to the CV) also be transferred to the FGR itself without prior consent being required. A closed FGR can redeem and subsequently re issue redeemed participations without consent of any of the participants[3]. Further reference is made to part (III.F).

2. Dutch classification of foreign entities

In the international tax arena, there are various non-Dutch entities which may be considered transparent or opaque from a Dutch tax perspective. The classification rules in that respect are laid down in a decree dated December 11, 2009 ("Decree")[4]. The Decree provides for rules and a classification framework in order to assess whether a foreign entity should be considered transparent or opaque from a Dutch perspective. Further reference is made to a publication thereon.[5]

In connection with the issuance of the Decree, on the website of the Dutch Revenue Service[6], a list was made available of pre-classified foreign entities. This list is to be updated regularly and is of an indicative nature only.

The pre-classified UK entities on the latest version of the list are:

- Limited Liability Partnership ("LLP"): Transparent[7]
- Limited Partnership ("LP")[8]: Comparable to the CV[9]
- Unlimited Company having a share capital: Opaque
- Private Limited Company: Opaque

D. Hybrid entities from a UK tax perspective

1. UK entities

With regards to hybrid entities from a UK tax perspective, typically the LP and the LLP should be mentioned. Both the LP and LLP are generally treated as transparent from a UK tax perspective, but may be considered opaque and thus hybrid from a non-UK perspective.

2. UK classification of foreign entities

In respect of the classification of a foreign entity for UK tax purposes, the website of the HMRC[10] provides further guidance. The HMRC indicates that various factors should be considered (based on the *Memec*-case[11]). An overall classification is reached from assessing all factors together. Similar to the Netherlands, the HMRC also provides for a list of pre-classified foreign entities on its website.[12] It is explicitly mentioned that the list only gives a general view.

The pre-classified Dutch entities on the list are:

- *Vennootschap onder firma* (general partnership): Transparent
- CV (both open and closed): Transparent
- *Naamloze vennootschap* (public limited company): Opaque
- *Besloten vennootschap* (private limited company): Opaque
- *Maatschap* (partnership): Transparent
- *Stichting* ("Dutch Foundation"): Transparent [13]
- *Co-operatie U.A.:* ("Co-operative")[14]: Opaque [15]
- *Co-operatie B.A.*: Transparent
- *Co-operatie W.A.*: Transparent
- FGR (closed)[16]: Transparent

E. Classification Conflicts

Based on the above, Classification Conflicts may arise for (i) the LP, (ii) the open CV, (iii) the Dutch Foundation and (iv) the Co-operative having the B.A. and W.A. form. However, Classification Conflicts in relation to application of the Treaty may also arise in respect of entities that are established in another jurisdiction. Examples thereof may be the French SCI (*Société Civile d'Immobilière*) and the Spanish SC (*Sociedad Collectiva*)[17], as well as several other entities that are from a Dutch perspective comparable to the CV (and may therefore be opaque or transparent

   ISSN 1754-1646

dependent on the implementation of the Consent Requirement in the entity's governing documentation). These Classification Conflicts will be addressed in more detail in Part III.

III. Article 22 and the Explanatory Notes

A. General

Article 22 (paragraphs 2 through 5) of the Treaty contain specific provisions as regards to hybrid entities and – in line with the OECD Report – provides solutions for the negative consequences of certain Classification Conflicts. The Explanatory Notes provide further guidance to these provisions by means of examples. The UK parliamentary proceedings did not further address these provisions and neither did the most recent Dutch parliamentary proceedings (*Nota naar aanleiding van het Verslag*) in June 2010. The provisions in paragraphs 3 through 5 of Article 22 and the Explanatory Notes are similar to the provisions and guidance under the US Treaty. To that effect, the provisions in both the Treaty and the US Treaty only apply to an item of income that flows from one state to another through an entity that is classified differently by each state. The provisions do not regard a difference in classification of the item of income itself.

B. Article 22, paragraph 2

Article 22, paragraph 2 reads as follows:

> 'Where a resident of a Contracting State is a member of a partnership established under the laws of the other Contracting State, nothing in the Convention shall prevent the first-mentioned Contracting State from taxing that resident on his share of any income, profits or gains of that partnership.'

The Explanatory Notes state that paragraph 2 has been included in the Treaty upon request of the UK to ensure that a Contracting State can levy tax from the participants in a hybrid entity. This provision is part of the UK treaty policy since the *Padmore*-case[18]. In the *Padmore*-case, a UK partner in a Jersey partnership sought exemption from its share in the partnership profits pursuant to the 1952 UK-Jersey tax treaty. This was upheld by the Court of Appeal but has meanwhile been reversed by legislation in the UK providing that where a partnership resident outside the UK is relieved from UK tax on income or capital gains by virtue of a tax treaty, a resident partner shall be taxed without regard to such tax treaty.

C. Article 22, paragraph 3

Article 22, paragraph 3 reads as follows:

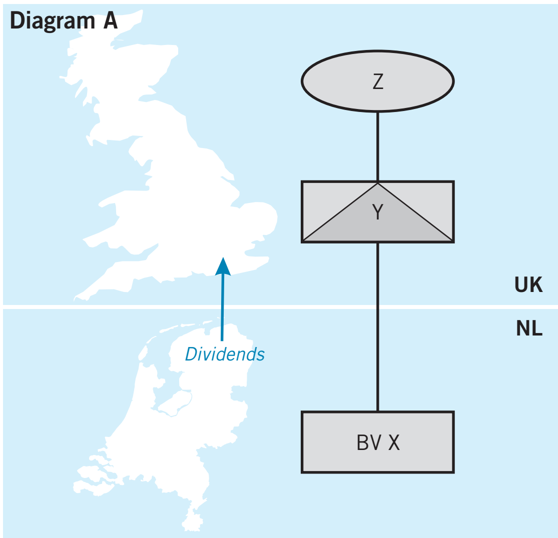
> 'In the case of an item of income, profit or gain derived through a person that is fiscally transparent under the laws of either State, such item shall be considered to be derived by a resident of a State to the extent that the item is treated for the purposes of the taxation law of such State as the income, profit or gain of a resident.'

This provision is similar to the principles included in the OECD Report and the wording is the same as Article 24, paragraph 4 of the US Treaty. The main idea of this provision is that the Source State, in applying the Treaty involving a hybrid entity, should take into consideration the way in which an item of income is treated in the Residence State of the taxpayer claiming the benefits of the Treaty. In other words, the Source State should follow the view of the Residence State. To clarify, the Explanatory Notes contain the following examples.

1. Example 1 - Diagram A

Z is an individual residing in the UK and participant in Entity Y. Entity Y is established in the UK. Through Y, Z receives dividends from the Dutch resident corporation BV X. From a UK perspective, Y is considered transparent, whereas it is considered opaque from a Dutch perspective. Z is taxed in the UK for its worldwide income. For purposes of the Treaty, Z is a resident of the UK. Y is not 'liable to tax' as meant in Article 4, paragraph 1 of the Treaty. In the absence of Article 22, paragraph 3, doubts could arise as to whether Z would be the recipient of the dividends. Pursuant to paragraph 3 however, Z is considered to be the recipient of the dividends and the Netherlands may withhold 10 percent dividend tax. As the Residence State of Z, the UK may tax the dividends received but has to provide for a credit for the Dutch withholding tax. In this example (which is similar to example 4 of the OECD Report), as the Source State, the Netherlands follows the entity's classification from a UK perspective for purposes of entitlement to the Treaty.

This Classification Conflict was from a Dutch perspective to a certain extent already mitigated pursuant to a decree dated March 19, 1997[19], which provides for the possibility of applying the same 'look-through' approach for foreign residents investing in a Dutch resident corporation through a hybrid entity, which is opaque from a Dutch perspective and transparent from the foreign state's perspective.



2. Example 2 - Diagram B

Same as example 1 above, albeit that in this example, Entity Y is transparent from a Dutch perspective and opaque from a UK perspective. Y is taxed in the UK for its worldwide income and is considered resident of UK and the beneficial owner of the dividends. Hence, the Netherlands will need to apply the article on dividends (and consider Y as the recipient) and the UK may provide for a credit for Dutch withholding tax (if any). Again, as a Source State, the Netherlands follows the entity's classification from a UK perspective for purposes of entitlement to the Treaty. This example is similar to example 5 of the OECD Report.

3. Example 3 - Diagram C

Z is an individual residing in the UK and participant in Entity Y. Entity Y is established in a third state. Through Y, Z receives dividends from the Dutch resident corporation BV X. From both a UK and Dutch perspective, Y is considered transparent.[20] Hence, there is no Classification Conflict that needs to be solved and Article 22, paragraph 3 is not of relevance. Z is taxed in the UK for its worldwide income and is thus resident of the UK for purposes of the Treaty. Pursuant to the Treaty, the Netherlands may withhold 10 percent dividend tax, and as the Residence State of Z, the UK may tax the dividends received but has to provide for a credit for the Dutch withholding tax. This example is similar to example 2 of the OECD Report.

Diagram B

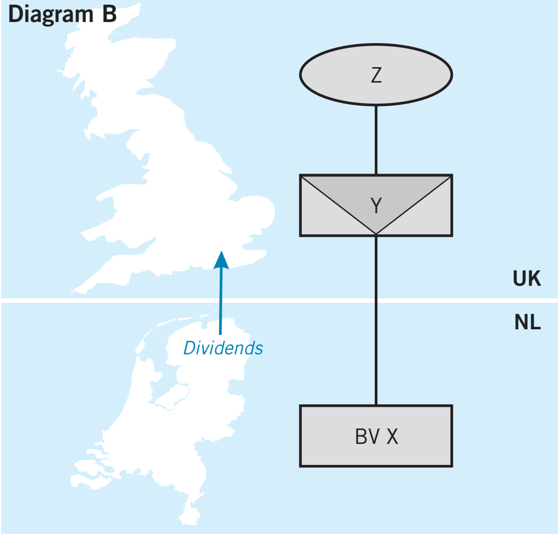
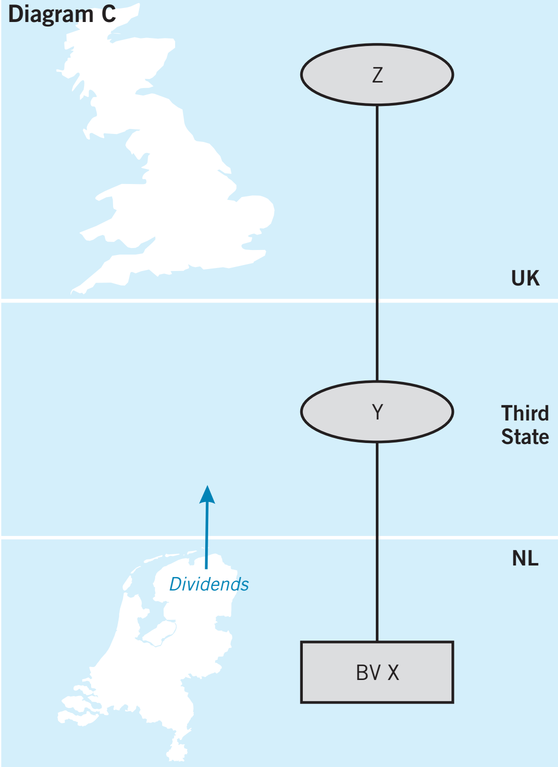


Diagram C



4. Example 4 - Diagram D

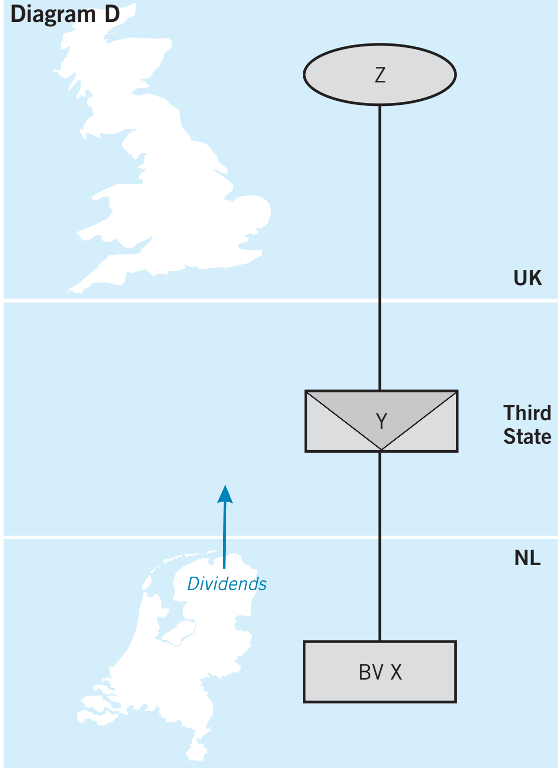
Z is an individual residing in the UK and participant in Entity Y. Entity Y is established in a third state. Through Y, Z receives dividends from the Dutch resident corporation BV X. From a UK perspective, Y is opaque, whereas it is considered transparent from a Dutch perspective. Z will not be taxed in the UK for the dividends distributed by BV X and neither will Y as it is not a resident of the UK. In other words, Y is not a resident for purposes of the Treaty and there is no income allocable to Z. For that reason, the Netherlands will not have to provide for a reduction of Dutch dividend withholding tax. This example is similar to example 3 of the OECD Report.

D. Article 22, paragraph 4

Article 22, paragraph 4 reads as follows:

> 'Where, by virtue of paragraph 3 of this Article, an item of income, profit or gain is considered by a State to be derived by a person who is a resident of that State and the same item is considered by the other State to be derived by a person who is a resident of

Diagram D



> that other State, that paragraph shall not prevent either State from taxing the item as the income, profit or gain of the person considered by that State to have derived the item of income.'

This provision is also in line with the OECD Report and the wording is the same as Article XIV (a) of the Memorandum of Understanding to the US Treaty. The main idea of this provision is that it is not the intention of paragraph 3 to deny all the taxation rights of the Source State. To clarify, the Explanatory Notes contain the following example.

1. Example 5 - Diagram E

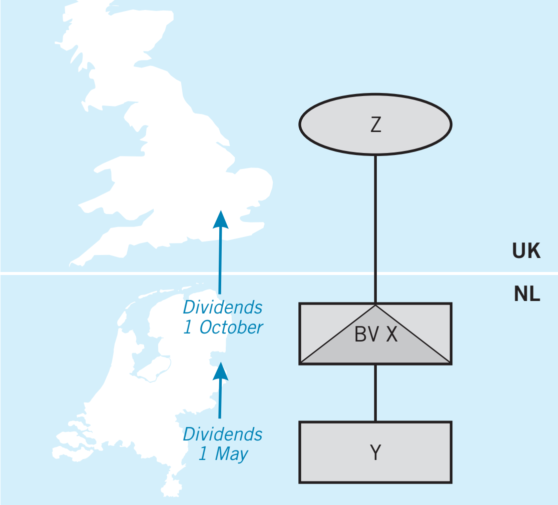
Z is an individual residing in the UK and sole shareholder of the Dutch resident corporation BV X. In turn, BV X is the sole shareholder of the Dutch resident Entity Y. From a Dutch perspective, both BV X and Y are opaque, whereas BV X (in this example) is considered transparent from a UK perspective. On May 1, Y distributes dividends to BV X, which are subsequently distributed onwards by BV X to Z on October 1. From a UK perspective, the dividend distribution made by Y to BV X is considered to be received by Z. Paragraph 4, does not result in the Netherlands being denied to apply its domestic laws. Hence, Dutch domestic law applies to the dividend distributions by Y to BV X on May 1. For the dividend distribution by BV X to Z on October 1, the Netherlands may withhold 10 percent Dutch dividend tax. This example is similar to example 17 of the OECD Report.

E. Article 22, paragraph 5

Article 22, paragraph 5 reads as follows:

> 'The competent authority of a State may grant the benefits of the Convention to a resident of the other State with respect to an item of income, profit or gain, even though it is not treated as income, profit or gain of the resident under the laws of that other State, in cases where such income would have been exempt from tax if it had been treated as the income of that resident.'

Diagram E

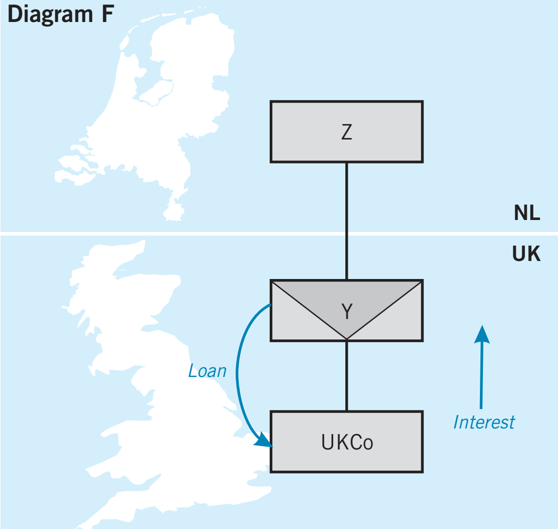


This provision is aimed at pension schemes, which are defined in Article 3, paragraph 1(I) and also qualify as a 'resident' in Article 4, paragraph 2 of the Treaty. The wording is the same as Article XIV (b) of the Memorandum of Understanding to the US Treaty. To clarify, the Explanatory Notes contain the following example.

1. Example 6 - Diagram F

Z is a pension scheme as meant in Article 3, paragraph 1(I) of the Treaty and is a resident of the Netherlands for purposes of the Treaty. Z is a participant in Entity Y, which is established in the UK and transparent from a UK perspective, whereas it is considered opaque from a Dutch perspective. Y holds shares in and provides a loan to a UK resident corporation. As the interest payment by the UK resident corporation is not deemed to be received in the Netherlands by Z, but instead by Y, Z is not entitled to the benefits of Article 11 of the Treaty. For that reason, the UK does not have to apply the Treaty to these payments of interest. In order to avoid that specifically pension schemes are hindered from investing through such entities, Article 22, paragraph 5 provides that in the underlying case, the UK competent authorities may determine that Z is entitled to the benefits of the Treaty.

Diagram F



F. Other

In respect of the above, it should also be noted that very recently, the Dutch and UK competent authorities reached mutual agreement regarding application of the Treaty to participants in a closed FGR. Based on this agreement, a closed FGR[21] receiving UK source income may claim tax treaty benefits on behalf of its participants, meaning that the closed FGR is considered transparent from both a Dutch and a UK perspective. Although the list on the website of the HMRC (see part II.D) indicates that a closed FGR is transparent from a UK perspective, confirmation of such classification by means of a mutual agreement provides more certainty. The Dutch Ministry of Finance has recently also reached a similar mutual agreement with Canada[22] and has indicated that they also aim to do so with various other jurisdictions such as the US. The above will presumably encourage asset pooling through a closed FGR and seems to arise from the OECD Report on Granting of treaty benefits with respect to the Income of Collective Investment Vehicles that was issued in May 2010.

IV. Concluding remarks

Where the Current Treaty does not provide solutions for the negative consequences of Classification Conflicts that arise from hybrid entities, in line with the OECD Report and the reservations made thereto by the Netherlands, the Treaty (which is not yet in force) does provide solutions for certain Classification Conflicts. The examples in the Explanatory Notes provide further clarification. It should however be noted that there are also Classification Conflicts that the Treaty does not provide solutions for.

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NOTES

[1] The UK also endorsed the principles of the OECD Report but did not express reservations to its content.
[2] See further the decree dated January 11, 2007, no. CPP2006/1869M.
[3] See further the decree dated January 11, 2007, no. CPP2006/1870M.
[4] No. CPP2009/519M.
[5] Michiel Beudeker, The new classification decree, BNA Tax Planning International European Tax Service, 03/2010. http://www.belastingdienst.nl/download/2440.html
[6] http://www.belastingdienst.nl/download/2440.html
[7] Given the characteristics of an LLP and the classification rules, this classification may in certain circumstances be questioned.
[8] Remarkably, no distinction is made between an English and a Scottish LP. A Scottish LP does have legal personality whereas an English LP does not.
[9] Where a foreign entity is comparable to the CV, the decisive criterion is also the Consent Requirement.
[10] http://www.hmrc.gov.uk/manuals/intmanual/INTM180010.htm
[11] Memec plc versus Commissioners of Inland Revenue (70 TC 77).
[12] http://www.hmrc.gov.uk/manuals/intmanual/INTM180030.htm
[13] The Dutch Foundation is in principle opaque from a Dutch perspective.
[14] The Co-operative can take the form of (i) an unlimited Co-operative, (ii) a limited Co-operative, or (iii) a Co-operative with excluded liability. Respectively, the letters W.A., B.A., or U.A. should be added to the name (being the Dutch abbreviations). The members of an unlimited Co-operative are, at the time of voluntary or involuntary dissolution, generally liable for the debts and obligations of the Co-operative. The members of a limited Co-operative are only liable up to the amount specified in the articles of association, and the members of a Co-operative with excluded liability do in principle not have any liability towards creditors of the Co-operative.
[15] The Co-operative in all its forms of liability is opaque from a Dutch perspective.
[16] Remarkably, the open FGR is not mentioned in the list, whereas the CV is mentioned in both forms.
[17] Based on the mentioned lists (albeit indicative), the SCI and the SC are transparent from a Dutch perspective and opaque from a UK perspective
[18] Padmore versus Commissioners of Inland Revenue, Court of Appeal, May 19, 1989, S.T.C. 493.
[19] No. IFZ97/204.
[20] Although the Explanatory Notes do not address this point, for purposes of this example, I assume that Y is also transparent from the third state's perspective.
[21] No. IFZ2010/534M
[22] No. IFZ2010/284M.

Belgium international professional associations: A helicopter view of the tax regime

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The authors present comprehensive information on the income tax and VAT issues affecting by "international non-profit institutions", being very commonly established entities in Belgium.

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I. General context

Brussels hosts most of the EU institutions (Commission, Council and Parliament). It is therefore not surprising that the "capital of Europe" is one of the most lobbied cities in the world: approximately 15,000 lobbyists are interacting each day with the EU decision-makers[2].

Entities from several EU countries, which are active in the same sector, often choose to form an "International non-profit association" ("*internationale vereniging zonder winstoogmerk*" / "*association internationale sans but lucratif*")[3], with a view to represent and defend their interests before the European Institutions.

Around 1,800 international professional associations are based in Brussels, at a stone's throw from the European institutions. According to a recent survey realised by the Federation of European and International Associations Established in Belgium (FAIB), these associations employ more than 11,000 people and have an estimated budget of EUR 1,700,000,000. They are active in various sectors such as transport, construction, automotive, audio, financial, farming, pharmaceutical/healthcare, etc. It is worth mentioning, among others, the European People's Party, the European Association of Listed Companies, the Confederation of European Paper Industries, the European Foodservice & Packaging Association, the European Petrochemical Association, the European Organisation for Research and Treatment of Cancer, etc.

This contribution addresses the Belgian income tax and value added tax (VAT) aspects related to the operation of international professional associations in Belgium.

II. Income tax

A. Corporate income tax versus legal entities tax: financial impact

Whether an international professional association must be subject to tax on legal entities ("*Rechtspersonenbelasting*" / "*Impôt des personnes morales*")("TLE")

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or corporate income tax ("*Vennootschapsbelasting*" / "*Impôt des sociétés*") ("CIT") is a hotly debated issue.

Why does this issue matter?

If an international association falls under the TLE regime, tax will only be levied on *certain types of income* such as:

- Income from immovable property,
- Capital gains on the disposal of immovable property,
- Income from movable property (interest, dividends, royalties); and
- Secret commissions on certain costs.

Consequently, the association will not be taxed on subsidies, gifts, membership fees or any other income originating from its activities.

However, if the association is subject to CIT, *all types of income* will be taxed at the rate of 33.99 percent. More concretely, the association will be taxed on subsidies, gifts, membership fees and income resulting from its ordinary activities.

Needless to say that, in practice, international professional associations prefer to be subject to TLE.

B. Corporate income tax versus legal entities tax : distinguishing criteria

1. Introduction

The question whether an international professional association must be subject to CIT or TLE is relatively complex. It is true that, in principle, international professional associations based in Belgium are subject to TLE.

However, attention must be paid to the situation where the association starts carrying out operations of a profit-making nature ("*Verrichtingen van winstgevende aard*" / "*opérations à caractère lucratif*"). Indeed, if the association were to engage in profit-making activities, it could become subject to the CIT regime by virtue of Article 179 of the Belgian Income Tax Code ("ITC").

At first glance, this rule could become quite problematic for international professional associations. Indeed, besides representing and defending the professional interests of their members before the European authorities, international professional associations frequently carry out profitable activities such as sales of publications, gathering of information, organisation of seminars, conduct of research and market studies, etc.

However, it is crucial to stress that such associations may still avoid the application of the CIT regime (and become subject to TLE), provided that the "*main or exclusive*" social object of the association consists in the "*study, protection and promotion of the professional and interprofessional interests of their members*" (Article 181, 1° ITC).

2. Is the lobbying activity the "main or exclusive object" of the international association?

Assessing whether the lobbying activity is the "*main or exclusive*" purpose of the association represents thus the decisive criterion for determining whether the association must be subject to CIT or TLE.

It could be adequate to adopt a *case-by-case approach*, i.e. to analyse the very nature of the activities of the international professional association in question. Unfortunately, it is not possible to ascertain a consistent attitude of the Belgian tax authorities and case-law: the outcome (i.e., CIT or TLE) will in most cases depend on the subjective evaluation of the facts performed by the taxman/judge.

From a practical perspective, the statutory purpose contained in the articles of association and, more importantly, the activities *actually* performed by the association will play a key role in practice.

According to the parliamentary works regarding Article 181 ICT, the Belgian tax authorities should, in view of establishing whether the activities performed by the association consist "*mainly or exclusively*" in the defence and representation of the interests of its members, take into account the relation between:

- "The sum of the membership fees, gifts, subsidies, the gross profit derived from activities carried out *within* the scope of the statutory purpose and the income derived from investments"; and
- "The gross profit derived from activities carried out *outside* the scope of the statutory purpose"[4].

If the major part of the gross profit of the international professional association is generated by activities falling outside the scope of the lobbying activity (see b), the association will be subject to the CIT regime[5].

Furthermore, the administration stated:

> "*private services rendered by professional organisations (e.g. lobby groups) to their members fall within the statutory purpose of the organisation, to the extent that those services are related to the professional interests of the members. The profit of these activities should consequently be seen as a membership fee provided that the cost of such services is tax deductible at the level of the beneficiary*".[6]

3. Illustration

These principles are nicely illustrated by the ruling rendered by the Court of Appeal of Mons on April 14, 1995. In the case at hand, a professional association, whose statutory purpose consisted in ensuring the promotion and protection of the professional, social and economic interests of its members, assisted its members in tax audits. The tax authorities argued that the association was in fact an accounting and bookkeeping services company, subject to the CIT regime.

According to the Court, the association's main purpose was the promotion of the interests of its members (lobbying activity); the accountancy services rendered to the individual members were, based on the facts of the case at hand, clearly accessory. Therefore, the Court of Appeal reversed the tax authorities' decision and held that the association was subject to TLE[7].

III. Value Added Tax

A. Introduction

The VAT status of international professional associations is a very controversial and debated issue[8]. A judgement of the Tribunal of Brussels of March 6, 2008 (which will be commented below) shows the problems that they are currently facing in the field of VAT.

The question arises whether international professional associations must be considered as VAT exempt "lobbying organisations" within the meaning of Art. 44, § 2, 11 of the Belgian VAT Code ("VATC") / Article 132,1,I of the VAT Directive 2006/112/CE ("VAT Directive").

B. Advantages and drawbacks of the registration of international professional associations for VAT purposes

If the activities of the association are caught by the VAT exemption (the association exclusively performs "lobbying functions", *i.e.* the defence and representation of the collective interests of its members vis-à-vis the relevant decision-makers), the association will not be registered for VAT purposes in Belgium.

As a result, the membership fees will not be subject to VAT, which could turn out to be advantageous for the association's members if they are not entitled to deduct input VAT. Another advantage is that the association can avoid costly and cumbersome VAT obligations (issuing VAT invoices, filing monthly or quarterly VAT returns, paying VAT to the VAT authorities, etc.). The drawback is that the association will not be able to deduct input VAT. More concretely, VAT incurred on services (*e.g.*, advisory fees, market studies outsourced by the association to third-party service providers, building costs, etc.) rendered to the association will constitute a (non-recoverable) cost.

On the other hand, if (part of) the activities of the association fall outside the scope of the VAT exemption (i.e., the association not only performs lobbying activities but also renders specific services to its members), the association will in principle need to register in Belgium for VAT purposes. The advantage is that the association will then have the right to deduct part of the input VAT. This will particularly be to the association's benefit in the event that it supports important costs.

C. Scope of the VAT exemption applicable to lobbying activities

Defining the exact scope of the VAT exemption is key in order to determine the VAT status of international professional associations.

Article 44, § 2, 11° VATC, which transposes into Belgian law Article 132,1,I of the VAT Directive, states:

> "*the supply of services and the supply of goods closely linked thereto, to their members in their common interest in return for a subscription fixed in accordance with their rules by non-profit making organisations with aims of a (. . .) trade-union, (. . .) nature (. . .)*" are exempt from VAT.

In the case of *The Institute of the Motors Industry*, the European Court of Justice ruled that the exemption laid down in Article 132,1,I of the VAT Directive only catches activities of a "trade-union" nature. More precisely, the exemption only applies to activities of non-profit making organisations that consist in

> (i) "*defending and representing the collective interests of its members vis-à-vis the relevant decision-makers*" and providing the members "*with a representative voice and strength in negotiations with third parties*"[9].

Specific services supplied by an international professional association to its individual members which *do not serve the collective interests of the members*, should therefore not fall within the scope of the exemption. In other words, if in reality payment is made in return for services provided by the association to the individual members rather than for syndical actions in the collective interests of the members, then the payment made by the member to the association should be subject to VAT.

The statutory purpose contained in the articles of association and, more importantly, the nature of the activities actually performed will be the decisive factors in assessing the VAT status of the international professional association.

By way of illustration, the following services rendered by an international professional association to its members should in our view fall outside the scope of the exemption and be subject to VAT:

- Legal advice;
- Social and/or accounting services; the Belgian ruling commission[10] recently stated in this respect that administrative assignments ("*services de secrétariat social*"/ "*prestaties van sociaal secretariat*") such as net salary computation, computation of professional withholding tax and social security contributions performed by an association in favour of some of its members were subject to VAT;
- Editing of publications/website which serve the purpose of informing members about all matters of mutual interest;
- Conduct of research, collection and distribution of scientific information concerning the legal, economic and social status of the firms in the relevant sector;
- Organisation of seminars; and
- Gathering information about all matters of mutual interest, etc.

The association's general lobbying activity (*e.g.*, ensuring a permanent link with the European Union and with all other international bodies with a view to represent and defend the professional interests of its members as a whole; influencing EU decision-makers; strengthening the network and relations with strategic partners at EU level, etc.), will, however, be VAT exempt.

D. Qualification of international professional associations as a "mixed" VAT payer

In practice, international professional associations generally perform both (taxable) individualised services and (VAT exempt) lobbying activities for their members. In such case, they should be qualified as "mixed" VAT payers and be entitled to deduct part of the input VAT.

Based on the circular letter no. 12 of December 29, 1986[11], the membership fees invoiced by an association to its members need to be allocated so that

- The part linked to the lobbying activities is exempt from VAT (and does not give rise to a right to deduct input VAT); and
- The part linked to the individualised services is subject to VAT (which enables the association to deduct VAT).

In this respect, it is worth mentioning the decision of the VAT authorities dated August 17, 1987 (E.T. 59563), according to which 80 percent of the activities of professional associations active in the major sectors constitute individualised services (subject to VAT and giving rise to a right to deduct of input VAT).

Under this approach the association's right to deduct input VAT should be computed by using the following pro rata: taxable activities compared to the total activities (taxable and VAT exempt) of the association.

By way of example, if the income derived from general lobbying activities is equal to 100,000 EUR, while the amount of the income generated by specific services rendered to individual members is equal to 400,000 EUR, the association could deduct 80 percent (400,000 / 500,000) of the incurred input VAT.

E. Latest developments

Unfortunately, the VAT administration has recently reviewed its position. The Minister of Finance has indicated in 2006 that:

> *"when an association is rendering services, even if individualised ones, to its members that enter within the scope of its statutory purpose as a professional association or when the association is editing a website or a magazine to inform its members, these activities should be seen as linked to the lobbying activities"*.[12] Such activities *"should not prevent the application of Article 44, § 2, 11° VATC to the part of the membership fee which covers these services"*, except for the activities that *"fall clearly outside the framework of the organisational aims"*
> which will be subject to VAT.

By adopting such a strict interpretation of Article 44, § 2, 11° VATC, the Finance Minister has greatly reduced the international professional associations' right to deduct input VAT. This administrative position is clearly not in line with the ECJ judgement in the case of *The Institute of the Motors Industry* [13].

The recent judgment of the Tribunal of Brussels dated March 6, 2008 is quite worrying. In the case at hand, an international professional association (AISBL), that defended the interests of its members active in the audiovisual sector, had deducted input VAT.

According to the VAT authorities, the association was not entitled to deduct input VAT on the basis of Article 44, § 2, 11° VATC, as its activities were of a "trade-union" nature. The Tribunal endorsed the VAT administration's point of view. The judge indicated that the lobbying activity was clearly the *principal activity* of the association, while the taxable activities (studies) were "marginal".

Based on non-official sources, the VAT authorities have drafted a new circular on the VAT status of professional associations, which has not yet been published. It is hoped that the administrative guidelines will now be in line with Article 132,1,I of the VAT Directive and the ECJ judgement in the case of *The Institute of the Motors Industry*.

IV. Various taxes

Finally, we would like to stress that gifts made to an AISBL are, as a rule, submitted to registration duties (*"droits d'enregistrement" / "registratierechten"*) at a rate of 7 percent. This tax is reduced to a lump sum of EUR100 if the grantor is a non-profit entity established in the European Community.

Furthermore, an AISBL is also subject to an annual tax in lieu of inheritance tax (*"Taxe compensatoire des droits de succession"/"Belasting tot vergoeding der successierechten"*) at a rate of 0.17 percent. The tax is due on the assets of the entity; however, if the assets are worth less than EUR 25,000 no tax is due.

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NOTES

[1] Special thanks to Denise Van Hentenrijk for the careful revision of this article.

[2] Ph. LAMBRECHT, *Running an international association in Belgium*, 2010, UGA Publishers, 3.

[3] AISBLs are organised by Title III of the Act of 27 June 1921 governing the ASBLs, AISBLs and foundations.

[4] Parl. St. Chambre 1975-1976, nr. 879/7, 31

[5] Com, IR 92, n°181/5. See also D. DESCHRIJVER, *VZW en Belastingen*, Kalmthout, Biblo, 2005, 105.

[6] Com, IR 92, n°181/6. See also R. HENDRICE and X. GERARD, "Les impôts directs", in *La fiscalité des ASBL*, Louvain,-la-Neuve, Anthemis, 2007, 35.

[7] Mons, 14 April 1995, F.J.F., 1995/236

[8] See in this respect : D-E PHILIPPE, "La TVA et les associations professionnelles internationales : état des lieux", *Actualités fiscales*, 11 March 2009, 1-4. Also F. BALTUS and A. SORIANO, "Les associations professionnelles internationales, les prestations syndicales et la TVA", *JDF*, 2009, 6-17.

[9] ECJ, November 12, 1998, C-149/97, The Institute of the Motor Industry v. Commissioners of Customs and Excise.

[10] Ruling of March 16, 2006 (n° 500.135)

[11] See in this respect : D. DESCHRIJVER, *op.cit*., 317 - 323; V. SEPULCHRE, «La taxe sur la valeur ajoutée», in *ASBL, fondations et associations internationales*, Bruges, La Charte, 2004, pp. 509 - 515.

[12] Q. & R. Sénat 2005-06, 12 July 2006, p. 7907 – Gest. 3-74, NYSSENS

[13] See also Y. MASSIN, «Groupements professionnels d'employeurs : vers une exemption totale?», *Fiscologue* of 23 Februar 2007, 7.

Termination of France-Denmark tax treaty: iron fist in velvet glove?

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The authors discuss the impact of the recent termination of the tax treaty between France and Denmark on incomes received from one Member State by tax entities resident in the other State.

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I. French tax authorities clarify and alleviate impact of treaty termination

In guideline 14 B-2-10, published on August 2, 2010 (the "Guideline"), the French tax authorities have clarified and alleviated with regard to certain points, the consequences of the unprecedented situation resulting from the termination of the tax treaty entered into between France and Denmark on February 8, 1957 (the "Treaty") and, more specifically:

- The effective date of termination;
- Its consequences for individuals and legal entities having their tax residence in Denmark ("Danish residents") who receive French-source income; and
- Its consequences for individuals and legal entities having their tax residence in France ("French residents") who receive Danish-source income.

A. Effective date of termination

As recalled in the Guideline, Article 28 of the Treaty enabled both States to notify the other State, in the first half of each year, of its intention to end the Treaty. In such case, the Treaty ceased to be effective as of January 1 of the year following the date of notification.

As Denmark had notified France of its decision to end the Treaty on June 10, 2008, the Treaty has ceased to have any effect since January 1, 2009.

In this regard, the Guideline indicates that the effects of the Treaty's termination will vary, depending upon the nature of tax and income in question:

- For withholding tax on income from equities, the Treaty ceased to be effective for payments made as from January 1, 2009;
- For tax levied on other income, the Treaty ceased to apply for tax levied on income relating to the calendar year 2009 and afterwards, or to fiscal years ended as from January 1, 2009, even if their taxation occurs after such a date; and
- For wealth tax, the Treaty ceased to be effective for wealth taxation as from January 1, 2009.

B. Consequences of the termination for Danish residents receiving French-source income

In the absence of a tax treaty between France and Denmark since January 1, 2009, the standard application of French domestic law provisions will have resulted in severe tax consequences for Danish residents, particularly as:

- It ends the situation whereby income and capital gains from real-estate assets located in France realised by Danish resident entities were not subject to taxation in either State; and
- It results in liability for withholding taxes provided for in French domestic law on all passive income (dividends, interest, royalties) and on French-source remuneration from provision of services.

 TPETS ISSN 1754-1646

1. Income and capital gains from real-estate located in France realised by Danish residents

Until the end of 2008, income and capital gains from real estate situated in France were:

- Subject to personal income tax in France when they were realised by a Danish resident individual; and
- Exempt from any tax, both in France and Denmark, when they were realised by a Danish resident entity, unless such real estate was held through a permanent establishment in France.

Since January 1, 2009, income from real estate situated in France held by Danish residents, either individuals or legal entities, is subject to taxation in France:

- Under the sliding scale of personal income tax (maximum marginal rate of 40 percent) if the beneficiary is an individual; or
- At a fixed rate of 33 1/3 percent if the beneficiary is a legal entity. The Guideline specifies that Danish resident entities owning real estate situated in France which become liable for French corporate income tax for the very first time are required to hold an opening balance sheet and to record their real estate assets at historical value, with depreciation retroactively as from their acquisition date; or
- At a fixed rate of 50 percent if the beneficiary is a real estate professional ("*marchand de biens*"), regardless of whether the latter is an individual or a legal entity.

Similarly, since January 1, 2009, capital gains on real estate located in France or equity interests held in preponderantly real-estate companies[1] realised by Danish residents are liable for tax in France, whether the seller is an individual or a legal entity:

- At the rate of 33 1/3 percent if the seller is a legal entity, reduced to 19 percent for capital gains from the sale of equities held for more than two years in listed preponderantly real-estate companies; or
- At the rate of 16 percent if the seller is an individual.

(i). Tax levied on other French-source income received by Danish residents

Pursuant to the Treaty, the French-source passive income (dividends, interest, and royalties) and remuneration from provision of services received by Danish residents, as well as capital gains from the sale of French equities were taxable exclusively in Denmark.

Since January 1, 2009, before being taxed in Denmark, these various sources of income are subject to French withholding tax, which is legally due by French debtors.

This withholding tax is in principle levied at the rates of:

- 25 percent for French-source dividends received by Danish legal entities, except for application of the parent-affiliate regime;
- 18 percent for French-source dividends received by Danish individuals;
- 18 percent for French-source interest, either by individuals or by legal entities (except for the application of the interest-royalties directive); and
- 33 1/3 percent for royalties and remuneration from provision of services.

Capital gains recorded by Danish residents since January 1, 2009 from the sale of equities issued by companies subject to corporate tax and having their registered office in France, are subject in France to a fixed 18 percent tax[2], except if the seller and his household[3] did not hold at any one time during the five years preceding the sale, directly or through an intermediary company, at least 25 percent of the capital of the company in which the equities were sold.

(ii). Measures included in the Guideline to ease the tax situation of Danish residents receiving French-source income

The tax Guideline includes two measures easing things for Danish Residents that receive French-source income:

- Firstly, the Guideline facilitates Danish residents' access to the withholding tax exoneration measures provided for in French domestic law;

> The Guideline specifies that for those provisions of the French Tax Code which are applicable subject to localisation in a State which entered into "*an administrative assistance clause aiming at fighting against fraud and tax evasion*", as is the case in particular for Articles 119 *ter* and 119 *quater* of the French Tax Code for dividends, interest and royalties respectively, this condition will be deemed satisfied as long as France and Denmark continue to provide each other with such administrative assistance.

The location in Denmark can be evidenced by the beneficiary by any and all means.

- Secondly, the Guideline provides that a Danish resident who was not able to deduct from the tax owed in Denmark the whole tax credit granted by domestic Danish law under the withholding tax deducted in France on his French-source income may apply, by way of a claim filed with the French tax authorities, for a refund of the part of the non-deducted tax credit within the limit of the French tax that he would have paid if he had been a tax resident in France.

C. Measures included in the Guideline to ease the tax situation of French residents receiving Danish-source income

While the Guideline is not intended to set out the taxation conditions in Denmark for Danish-source income received by French residents, it does however:

- Specify that the Danish tax authorities have introduced an exemption regime for certain pensions allocated to French residents; and
- Ease the situation for French residents that receive Danish-source income.

In principle, in the absence of a treaty and by way of the combined application of Articles 13[4] and 122[5] of the French Tax Code, French residents that, pursuant to French and Danish domestic law, are liable for tax both in France and Denmark for their Danish-source income, should not benefit from any tax credit in France for the tax levied in Denmark, but should be authorised to deduct such Danish tax from their taxable income in France.

Notwithstanding this, the Guideline provides that:

Table A: Danish-source income received by French tax residents

	Franco-Danish Treaty (February 8, 1957)	In the absence of any treaty (since January 1, 2009)	Improvements provided for in the draft Guideline
Dividends	• **In France:** no taxation • **In France:** income tax (income tax or corporate tax)	• **In Denmark:** 28 percent withholding tax • **In France:** Tax levied (income tax or corporate tax) on the net dividend of the Danish withholding tax.	• France grants a tax credit equal to the 28 percent withholding tax levied in Denmark, • Deductible (but not refundable) from the tax due in France (income tax or corporate tax) levied on the gross amount of the Danish-source dividends before the 28 percent withholding tax.
Interest		• **In Denmark:** No taxation or withholding tax • **In France:** tax levied on the total amount of interest (income tax or corporate tax)	N/A
Royalties		• **In Denmark:** 25 percent withholding tax • **In France:** Tax levied (income tax or corporate tax) on the net income of the Danish withholding tax.	• France grants a tax credit equal to the 25 percent withholding tax levied in Denmark, • Deductible (but not refundable) from the tax due in France (income tax or corporate tax) levied on the gross amount of the Danish-source royalties (before the 25 percent withholding tax).
Income and capital gains from real estate	Taxation in Denmark if the real estate is located in Denmark	• **In Denmark:** Tax levied in Denmark if the real estate is located in Denmark • **In France:** ● *Income from real estate:* ▸ For individuals: sliding scale for corporate tax levied on the net amount received ▸ For legal entities: corporate tax at the standard rate if the real estate is an asset owned by a French company. ● *Real estate capital gains:* ▸ For individuals: tax levied at a rate of 28.1 percent (16 percent +12.1 percent) on the net capital gains ▸ For legal entities: tax levied at a rate of $33\frac{1}{3}$ percent.	• France grants a tax credit equal to the tax levied in Denmark, • Deductible (but not refundable) from the tax due in France (corporate tax) levied on the total amount of real estate or the real estate capital gains derived from the sale (without any deduction of Danish tax).
Capital gains from a transfer of equities	Taxable in France	• **In Denmark:** no taxation • **In France:** ● *Capital gains realised by individuals:* tax levied at a global rate of 30.1 percent if the annual amount of sales by the tax household exceeds EUR 25,830. ● *Capital gains realised by legal entities:* CIT at $33\frac{1}{3}$ percent on the total capital gain (or only on 5 percent of its amount if the transferred equities fall within the long-term capital gains regime).	

- French residents subject to double taxation pursuant to domestic French and Danish rules benefit from a tax credit deducted from the tax due in France on their Danish source income (other than pensions) in an amount equal to the tax levied in Denmark.[6];
- Correlatively, a French resident is liable for tax in France on the amount of his Danish-source income. The tax for which a French resident is liable in France for his Danish income is limited to the excess between the tax thus calculated for each category of Danish-source income and the tax credit awarded to him;
- No excess tax credit relating to a category of income and not used in its entirety can be deducted from the tax due in France for another category of income;
- Thus, contrary to the Danish resident, the French resident cannot apply to the French tax authorities for a refund of the Danish tax that could not be deducted from his tax due in France; and
- Unless the Danish tax authorities grant French tax residents a refund of the part of the Danish tax not deducted from the French tax, the tax effectively levied on the French resident's Danish-source income therefore corresponds to the highest tax provided for in domestic law in each of these two States;

Please see Table A above and Table B overleaf showing the relevant impact of the Guidelines on French source income received by Danish tax residents and vice-versa for comparative reference.

In practice, this tax credit exemption measure granted by France outside of any treaty will benefit in particular French residents that have received one of the following since January 1, 2009:

- Danish-source dividends or royalties subject to withholding tax in Denmark (currently at the rates of 28 percent or 25 percent, except for application of the parent-affiliate directive or the interest-royalties directive); or
- Real-estate income or real-estate capital gains related to real estate located in Denmark.
- According to domestic Danish law, no tax is currently due in Denmark on Danish-source income and capital gains from the sale of holdings in companies established in Denmark[7] realised by persons with their tax residence outside Denmark.

While the French tax authorities have undeniably alleviated the consequences of the termination of the Treaty, these measures do not totally eliminate the double taxation levied on French residents for some types of their income pursuant to French and Danish domestic law.

That is why it is desirable that a new treaty be negotiated swiftly between France and Denmark.

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Table B: French-source income received by Danish tax residents			
	Franco-Danish Treaty of February 8, 1957	**In the absence of any treaty** (since January 1, 2009)	**Improvements provided for in the Guideline**
Dividends	• **In France:** No taxation or withholding tax • **In Denmark:** Income tax (income tax or corporate tax)	• **In France:** 18 percent or 25 percent withholding tax (unless exempt under the parent-affiliate rule), • **In Denmark:** tax levied on the gross dividends (income tax or corporate tax) with granting of a tax credit equal to the lowest of the following amounts: (1) the French withholding tax, or (2) the amount of Danish tax due on such dividends.	If the Danish resident has not been able to deduct in Denmark the whole tax credit corresponding to the French withholding tax, possibility for the Danish Resident to claim from the French tax authorities a refund of the part of the tax credit not deducted within the limit of the French tax he would have paid if he had been a tax resident in France.
Interest		• **In France:** 18 percent withholding tax, unless exempt (Article 131 quarter or EU Directive on interest and royalties). • **In Denmark:** tax levied on gross income (income tax or corporate tax) granting of a tax credit equal to the lowest of the following amounts: (1) the French withholding tax, or (2) the amount of the Danish tax due on such interest.	
Royalties		• **In France:** 33⅓ percent withholding tax unless exonerated (EU directive on interest and royalties). • **In Denmark:** Tax levied on gross royalties (income tax or corporate tax) granting of a tax credit equal to the lowest of the following amounts: (1) the French withholding tax, or (2) the amount of the Danish tax due on such royalties.	
Real estate income and capital gains	• **For legal entities:** no taxation in either State (unless the real estate is held by a permanent establishment in France). • **Individuals:** taxation in France if the real estate is located in France	• **In France:** • *Income from real estate:* ◗ For individuals: a sliding scale for income tax, with application of a minimum average rate of 20 percent. ◗ For legal entities: standard CIT rate of 33⅓ percent. • *Capital gains from real estate:* ◗ For individuals: 16 percent rate (increased to 50 percent if the transferor is a real estate professional). ◗ For legal entities: 33⅓ percent rate (increased to 50 percent if the transferor is a professional and reduced to 19 percent if the transferred equities are equities in an SIIC or the purchaser is an SIIC). • **In Denmark:** • For individuals: subject to tax on income and capital gains from real estate calculated in accordance with Danish tax law and with a credit for foreign taxes (the lower of (1) the French tax, or (2) the amount of the Danish tax due on such income or capital gains). • For legal entities: No tax on income from or capital gains on real estate located outside Denmark.	
Capital gains from a transfer of equities	Taxed in Denmark	• **In France:** 18 percent tax levied if the transferred equities come from holdings of more than 25 percent held directly or indirectly by an intermediary company, by the transferor with his household at any one time during the past five years (exoneration of capital gains from holdings of less than 25 percent). • **In Denmark:** Tax levied on the gross amount of capital gains (income tax or corporate tax) and Denmark grants a tax credit equal to the lowest of the following amounts: (1) the French withholding tax, or (2) the amount of the Danish tax due on the sale of shares issued by a French company.	

NOTES

[1] Legal entities established in or outside of France, whose worldwide assets are more than 50 percent constituted by real estate located in France or rights over real estate not used for business purposes, at the end of the three fiscal years preceding the sale.

[2] This deduction is only due if the annual amount of sales exceeds the tax threshold (i.e., EUR 25,830 for sales realised in 2010).

[3] Within the meaning of Articles 244 bis and 164 B (f) of the French Tax Code, the household includes the seller, his or her partner, their ascendants or descendants.

[4] Article 13 of the French Tax Code sets out the principle that taxable income is constituted after deduction of the expenses incurred with a view to its acquisition and conservation.

[5] Article 122 of the French Tax Code provides that income from equities issued in France are calculated without any deduction other than that of the tax established in the country of origin and whose payment is incumbent on the beneficiary.

[6] Even though it is rare to internally grant a tax credit (outside of the framework of the Treaty), it is not prohibited. This mechanism had already been put in place in 1976 within the framework of the relations between Vietnam, Laos and Cambodia.

[7] Which are not preponderantly real-estate based in nature.

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Termination of the Luxembourg Holding 1929 regime: avoiding adverse tax aspects

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Pursuant to the termination of the H1929 regime in Luxembourg by the European Commission in 2006, all H1929 companies are set to lose their tax exempt status by December 31, 2010 and will come under the country's corporate and wealth tax net. The author below discusses the impact of this change on the H1929 companies' tax liabilities.

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I. Introduction

The Luxembourg Holding 1929 (H1929) regime provides for a tax efficient framework for Luxembourg holding and financing companies. In 2006, the H1929 regime was declared prohibited State aid by the European Commission (Commission) and had to be terminated by December 31, 2010. By the end of this year all remaining H1929 companies will lose their tax exempt status and will automatically become subject to Luxembourg corporate income and net wealth tax. The shareholders and certain creditors of an H1929 company will become subject to Luxembourg withholding tax, unless an exemption applies.

This article first explains the main features of the H1929 regime. Secondly, the positions taken by the EU Code of Conduct group against harmful tax competition (Code of Conduct Group) and the Commission towards the H1929 regime are briefly described. Thirdly, the Luxembourg tax aspects of an H1929 company losing its tax exempt status are explained. Finally, this article describes some possibilities to avoid adverse Luxembourg tax consequences upon termination of the H1929 regime.

II. Tax aspects of the H1929 regime

A Luxembourg company subject to the H1929 regime is exempt from Luxembourg corporate income[1] and net wealth tax[2], but is subject to an annual subscription tax on the value of its shares.[3] The shareholders and certain creditors of an H1929 company are exempt from withholding taxes. In principle, an H1929 company can solely be engaged in passive holding activities as opposed to commercial or industrial activities. An H1929 company is allowed to grant interest bearing loans to its direct subsidiaries.

The H1929 regime appears in two other types. An H1929 company with a capital plus reserves exceeding EUR 24 million[4] can opt to be treated as a so-called billionaireH1929 company (BH1929).[5] BH1929 companies are upon request not subject to subscription tax, but are obliged to withhold tax (maximum rate 3 percent) on certain types of payments. Another

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type of the H1929 regime is the Financial 1929 company (F1929). An F1929 company benefits from the same tax regime as the H1929, but is allowed to finance companies within the group (not only direct subsidiaries).[6] The three different types are hereinafter all referred to as H1929.

III. H1929 regime under attack of the Code of Conduct Group and the Commission

On November 29, 1999 the Code of Conduct Group under the chairmanship of Dawn Primarolo issued a report to the ECOFIN Counsel containing a list of 66 measures that constituted harmful tax competition. The H1929 regime was mentioned in this list. The harmful element was the possibility for an H1929 to receive dividends from tax haven companies without a Luxembourg corporate income tax charge. As a consequence, Luxembourg amended its H1929 regime as per July 1, 2005. As from then, an H1929 company loses its tax exempt status if it receives in a certain book year at least 5 percent from its dividends from foreign companies that are not subject to comparable taxation (Low Tax Dividend Cap). Comparable taxation means an income tax rate of at least half of the Luxembourg corporate income tax rate[7] (Tax Test), which is levied on a similar tax basis. All the entities covered by Article II of the EU parent subsidiary directive (PDS)[8] are deemed to meet this test. The H1929 regime lost most of its appeal as a result of this amendment. H1929 companies existing prior to July 1, 2005 benefit from a grandfathering period until the end of 2010.

On July 19, 2006, the European Commission concluded that the H1929 regime constituted prohibited State aid, because the scheme grants unjustified tax benefits.[9] The Commission required Luxembourg to repeal the scheme by the end of 2006 with a grandfathering period for existing H1929 companies until the end of 2010. Luxembourg gave effect to the Commissions' conclusion and the H1929 regime could not be applied anymore after July 20, 2006 and terminated as from January 1, 2007. A grandfathering period was introduced for existing H1929 companies as from January 1, 2007 until December 31, 2010. By the end of 2010 all H1929 companies will lose their tax exempt status. The disposal of the shares in an H1929 company during the transitional period leads in principle to a loss of the H1929 status.

IV. Tax consequences of an H1929 company losing its status

H1929 companies losing their tax exempt status will become subject to Luxembourg corporate income and net wealth tax. The company will not be subject to subscription tax anymore. The shareholders and creditors of an H1929 company can become subject to withholding tax at the rate of 15 percent on dividends and certain types of interest. A step up in basis will be granted for corporate income and withholding tax purposes if an H1929 company loses its status. The tax accounts will show the fair market value of the assets and liabilities directly prior to the moment the H1929 loses its status. This revaluation is accounted for as a tax revaluation reserve. As a result of the step up in basis, profits realised after status loss are not subject to corporate income tax to the extent they are attributable to the H1929 period. The tax revaluation reserve, which is considered to be contributed capital, should not trigger withholding tax upon distribution, provided the distribution is made for sound business reasons.[10]

Whether actual adverse tax effects will be triggered after H1929 status loss depends on the type of assets of the H1929 company and the status of its shareholder(s). Income and capital gains, derived by a Luxembourg normal taxed company from its shareholdings are subject to corporate income tax, unless the participation exemption regime applies. The participation exemption regime applies if an at least 10 percent shareholding or a shareholding with an acquisition price of EUR 6 million is held (Threshold Test)[11] or committed to be held for at least 12 months (Holding Test)[12] in a company that meets the Tax Test or is covered by Article II of the PSD.[13] Net wealth attributable to participations that meet the Threshold Test and Tax Test will escape net wealth tax. A former H1929 company that meets these tests should, with respect to income, capital gains and net wealth attributable to participations, not be adversely affected after losing its status. Most H1929 companies will however hold assets not benefiting from the participation exemption (Non Qualifying Shareholdings). Income, capital gains and net wealth attributable to these assets will therefore become subject to taxation in Luxembourg.

The shareholders in a normal taxed Luxembourg company are subject to dividend withholding tax unless an exemption applies. In general an exemption applies if the shares are held by a corporate parent resident in a treaty country or a parent company that is covered by Article II of the PSD. The parent company must also meet the Threshold and Holding Test in respect of the Luxembourg shares to qualify for the exemption.[14] The shareholders of an H1929 company will often not meet these tests (Non Qualifying Shareholders) and dividend distributions will then become subject to withholding tax.

V. How to avoid or mitigate adverse Luxembourg tax consequences upon H1929 status loss?

A. Avoiding or mitigating adverse corporate income and net wealth tax consequences

To mitigate or to avoid adverse income and net wealth tax consequences in respect of Non Qualifying Shareholdings upon loss of the H1929 status it could be considered to shelter taxable income with an offsetting expense. The H1929 can, for instance, be refinanced by a conversion of its equity into debt. As from the moment of status loss, the tax deductible interest expenses on the debt will partially shelter the taxable income realised after 2010.[15] The net wealth tax basis will increase as a result of debt financing as well. It could also be considered to contribute Non Qualifying Shareholdings in a foreign intermediate holding company that does meet the conditions of the Luxembourg participation exemption and which company does not tax the income and capital gains derived from these Non Qualifying Shareholdings. As an alternative, it can also be considered to redomicile the H1929 to another favourable tax jurisdiction.

B. Avoiding or mitigating adverse withholding tax consequences

In general, debt financing also carries another tax benefit: interest payments are in general[16] not subject to Luxembourg withholding tax. It must be noted that a repatriation of funds to Non Qualifying Shareholders can also be done without withholding tax in the form of redemption payments on shares which are subsequently cancelled.[17] It could also be considered to introduce a parent company on top of the H1929 that qualifies for an exemption of Luxembourg withholding taxes and is established in a jurisdiction that does not levy withholding taxes itself. As an alternative it can also be considered to redomicile the H1929 to another favourable tax jurisdiction.

VI. Alternatives to the H1929 regime

Luxembourg introduced the so-called SPF regime (*Société de gestion de patrimoine)* as per May 11, 2007 as the successor of the H1929 regime. A company organised as an SPF is not a withholding tax agent[18] and is exempt from net wealth and income tax. The SPF loses its tax beneficial tax status if the Low Taxed Dividend Cap is not met in respect of non-listed shares. The SPF is subject to an annual subscription tax of 0.25 percent levied on its share capital plus premium plus outstanding debt to the extent it exceeds 8 times the sum of the share capital and premium.[19] An H1929 adopting the SPF regime must be held by an individual acting in the context of its private wealth, a private wealth entity acting solely for such individuals or intermediaries acting on behalf of either one. The activities of an SPF are limited to the acquisition, holding, administration and sale of financial assets and cash. An SPF is not allowed to grant interest bearing loans. An SPF may not conduct commercial activities and cannot interfere in the management of its subsidiaries. Since the SPF is of a passive nature it should not qualify as an undertaking and it should therefore be outside the scope of the European State aid rules.

The former H1929 company could also apply the SIF regime (*Fonds d'Investissement Spécialisé*). A company organised as an SIF is not a withholding tax agent and is exempt from income and net wealth taxes, but is subject to an annual subscription tax with a rate of 0.01 percent on its net asset value.[20] As a SIF is a fund type of entity it needs the approval of and is supervised by the Luxembourg financial authorities (*Commission de Surveillance du Secteur Financier*). The SIF has to meet a set of regulatory requirements and is amongst others subject to risk diversification rules. Luxembourg provides for alternative regimes that should provide for tax neutrality as well. The H1929 could, for instance, also consider applying the SICAR regime (*Société d'Investissement en Capital à Risque*) or the securitisation regime. These two regimes are however less likely to apply to passive holding and financing activities normally performed by an H1929 company.

The solution that will suit to avoid or mitigate adverse tax consequences upon termination of the H1929 status will depend on the facts and circumstance of the case at hand. One thing is, however clear: waiting is in most cases not an option, action is required!

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NOTES

1 The Luxembourg profit tax system consists of a national corporate income tax at a rate of 21 percent and a municipal business tax at a rate of 6.75 percent (rate applicable in Luxembourg City). In addition, there is a 4 percent surcharge for the employment fund calculated on the national corporate income tax. The total combined general corporate income tax rate is therefore 28.59 percent. On July 23, 2010 the government proposed to introduce a minimum annual corporate income tax charge of EUR 1,500 (for holding and financing companies) and to increase the surcharge to 5 percent, which increase would result in a total combined general corporate income tax rate of 28.8 percent in Luxembourg City.

2 Net wealth tax at a rate of 0.5 percent is levied on the net wealth of a company on January 1 of each year. Net wealth attributable to shareholdings is in general tax exempt.

3 The rate of the subscription tax is 0.2 percent. For unlisted companies the subscription tax basis is the nominal value plus share premium of the issued share capital. For listed companies the subscription tax basis is the average market value in the preceding year. If the distributed dividends of an H1929 company exceed 10 percent of the paid-up share capital, the subscription tax of the corresponding year is calculated over an amount which is equal to ten times the total distributed dividends in the relevant year.

4 This amount equals 1 billion Luxembourg Francs.

5 Pursuant to the decree of December 17, 1938.

6 Pursuant to the circular of September 9, 1965.

7 Since the general corporate income tax rate in Luxembourg is 21 percent the statutory foreign rate must at least be 10.5 percent.

8 These entities must meet the following conditions: the company has a qualifying legal form, is a tax resident of an EU Member State and is subject to income tax without the possibility of an option of being exempt.

9 Press release, July 19, 2006, IP/06/1021.

10 These are deemed not to be present if the company has distributable reserves, compare note de service LIR #113, October 3, 1985.

11 For the exemption of dividends an acquisition price of 1.2 million suffices. Losing the H1929 status does not have an effect on the original acquisition price of the company, in other words losing the H1929 status is not considered to be a new acquisition moment.

12 The holding period should not re-commence at the moment the H1929 status is lost.

13 A 50 percent exemption applies if the Threshold and/or Holding Test is/are met.

14 The holding period should not re-commence at the moment the H1929 status is lost.

15 Debt financing of a holding company should remain within the Luxembourg debt to equity ratio of 85/15.

16 This can be different for certain profit participating types of interest.

17 This practice is known as the partial liquidation and is typically approved by the tax authorities if all the shares of a certain class are redeemed and cancelled.

18 If interest is paid to an EU resident individual or to certain type of entities a 20 percent withholding tax could apply pursuant to the EU Savings Directive, if the creditor agrees with an exchange of information between Luxembourg and the country of residence this tax can be avoided.

19 The minimum annual subscription tax payable by an SPF is EUR 100 and the maximum is EUR 125,000.

20 Certain exemptions apply for investments in pension and money market funds and funds that are already subject to subscription tax.

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Most recent tax changes in Lithuania

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Lithuanian government is taking measures to step up and encourage businesses and corporate investments in the country. The author outlines the numerous changes aimed at increasing financial stability and attracting foreign investments.

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I. Background

In 2009, Lithuania and other Baltic countries faced a difficult challenge combating financial instability. Lithuania increased most taxes to offset economic losses and bolster public finances in 2008-2009. However, 2010 has started with ease, as the tax burden has decreased. As a result, Lithuania remains attractive to foreign investors because of favourable tax planning opportunities. Notably, the corporate income tax has dropped to 15 percent (from 20 percent). Moreover, small businesses that employ 10 or fewer employees and have annual income of LTL 500,000 or less are eligible for a special 5 percent corporate income tax rate (previously 13 percent). Also, a new law allows the transfer of losses from 2010 and earlier between a Lithuanian resident parent company and its domestic subsidiaries. Other 2010 tax developments are outlined below.

II. New developments in Lithuanian tax laws

A. It will be easier for companies to write-off bad debts

The administrative burden for the recognition of bad debts to be allowable deductions, leading to a lowering of the taxable income, has been reduced for companies. The administrative burden has reduced as the rules governing the burden of proof of debts gone bad or irrecoverable and their calculations have been changed (approved by the Minister of Finance) and have come into force recently. Its essence is to simplify the requirements for certain bad debts approving documents.

One of the most important changes to the rules is that the threshold limit of those debts which will no longer required to be proven as bad by documentary evidences has been doubled and now, in place of the old system, a simpler procedure will be applied for the recognition of bad debts.

In addition, companies also no longer need to have documents to prove small debts which have gone bad and irrecoverable nor do they have to prove their efforts taken to recover such debts and even in situations where the debtor is a separate legal entity. So far, this provision was applied only to situations where the debtor whose debts had to be written off was an individual.)

In addition to the above, new rules have come into force to prescribe certain mandatory documents' alternative in the rules. For instance, to prove bad debts, resulting from a company's bankruptcy it will now be sufficient to show a document proving the status of the company, which was liquidated due to bankruptcy, its deregistration from the register of legal persons.

Earlier, before these changes, it was necessary to produce or show a final court order effecting the liquidation of the company due to bankruptcy, or alternatively, a resolution at the creditors' meeting to declare the company's liquidation due to bankruptcy.

These and few other changes to the rules will be applicable in calculating taxable income of the year 2010 and for subsequent tax periods.

B. Business certificates will be issued on more flexible conditions

According to the proposal of the Ministry of Finance, the conditions on which people who obtain business licences are made more flexible; they can now pay a fixed-rate income tax on the individual activities carried out during the operational period.

As a result of this, the amount of tax payable will directly depend on the period for which the business certificate is used, i.e. if a person is issued a business certificate for 10 days, he will be liable to pay tax for

10 days. Prior to this, there was no option to use the business certificates for periods shorter than a month and hence, there was also no flexibility for tax amounts payable.

Previously, the minimum period of usage of business certificates was one month. After the changes, business certificates will be issued for a period of five days and a longer period (excluding commercial business licences, which will be issued for the preferred term, even if required, for just one day). Under the previous rules, even if a resident conducted individual business activities, for just a short period of five days, he had to pay a fixed- rate income tax for a whole month, because this was the minimum period available for business certification. Now, after the changes, the individual will pay pro-rata income-tax for the period for which his business certification was awarded. Thus, if the individual acquires a business certificate, for a period of five days, he will pay income tax at a fixed- rate applicable only for five days.

It is believed that this decision will contribute to business competitiveness, increase employment opportunities, and reduce the informal economy.

When the person was taxed on one-month basis and there was no option to acquire business certificate for shorter term, it led to the fact that people willing to engage in certain activities for a shorter term moved to informal (grey or hidden) economy. They chose not to apply for business certificates and instead evaded taxes.

C. Complex real estate agreements

Tax authorities, alerted to a series of complex financial transactions between related parties, have concluded that the transactions did not have a legitimate business purpose and were undertaken solely to decrease the main party's tax liability. An individual acting on behalf of a Swiss company entered into a variety of agreements under which the same property was sold numerous times in order to artificially increase its value for tax purposes. The individual did not declare income received from a company in Lithuania and did not pay any taxes on the profits derived from the sale transaction. The individual was assessed to tax for an amount of LTL 1 million.

D. Value Added Tax

Starting this year, taxpayers may apply for a refund of VAT paid in other EU member states by filing an electronic form with local tax authorities in Lithuania. The local tax authorities will forward the application to the tax administrator in the applicable EU member state. Lithuania's VAT rate increased to 19 percent from 18 percent in January 2009 and to 21 percent from 19 percent on September 1, 2009. During a transitional period that runs through December 2010, the 19 percent tax rate will apply for cigarettes and manufactured tobacco if the excise duty stickers for those products were ordered before September 1, 2009. In July 2009, Lithuanian President Ms. Dalia Grybauskaite signed a law introducing a reduced VAT rate of 9 percent for the heating of residential premises and water. The reduced rate will be in force through August 31, 2010.

E. Advance VAT

The decision to exempt business from paying the advance payment of VAT supports local companies facing adverse financial situations. These resources can be used for other needs, and in addition, this will reduce company's administrative burden.

Paying attention to the needs of business and opportunities, the Government approved the Finance Ministry's proposal to increase the limit under which companies are required to pay the advance payment of VAT from LTL 1,00,000 up to LTL 10 million. Companies, which are exempted from paying the advance payment of VAT, will pay a monthly sum towards VAT.

Only very large companies, with high turnover and whose activities are mainly focused on the domestic markets and domestic consumption, will have an obligation to pay the advance payment of VAT. However, these advance payments of VAT will help to avoid higher tax burden after the tax period when they are required to pay the full amount of tax. In addition to this, exports are subject to VAT at a rate of 0 percent.

Currently, the advance payment of VAT is required when company's average amount paid to the budget for the fiscal period, within three consecutive calendar months is higher than LTL 1,00,000.

F. Corporate income tax

In addition to the tax breaks for corporations and small businesses, the withholding tax on interest will be revoked if the interest is paid to legal entities registered or organised within the European Economic Area. The same rule applies for countries with which Lithuania has signed an income tax treaty. As of 2010, a corporate tax exemption is available for budget-financed institutions, Lithuanian banks, state and municipal institutions, agencies, and organisations; state company deposit and investment insurance programs; and European Economic Interest Groupings.

G. Investment projects

Until 2013, companies can take part in investment projects that offer attractive tax benefits. Companies can invest 50 percent of their profits into long-term assets used in the production of new products or services, to increase capacity, or to implement new processes and technologies, and the reinvested profit will not be included in the companies' taxable income. Investment in the replacement of production assets with similar new assets will not, however, be deemed a tax beneficial investment project.

H. Personal income tax

The personal income tax rate in Lithuania remains at 15 percent. Dividends and other profit distributions are taxed at a rate of 20 percent. Amendments to the Law on Personal Income Tax came into force in August 2009. The law provides a complete list of benefits in kind and lists income that will not be classified as a benefit in kind for the tax period starting in 2010. The amendment to the Law on Personal Income Tax sets a new rule for the calculation of non-taxable income, a benefit that will no longer be available to members of non-limited liability companies.

I. Excise duty

As of January 1, 2010 electricity is taxed by way of an excise duty. The amended Law on Excise Duty states that for one megawatt-hour of electricity, there will be two excise duties applicable: LTL 3.5 and LTL 1.8. A second excise duty of LTL 1.8 applies to electricity used for business purposes. The excise duties on electricity apply to owners of excisable goods warehouses, registered and unregistered traders, and persons manufacturing or using excise-free energy products, alcohol, alcoholic drinks, or tobacco for purposes other than the established purpose. For imports, the excise duty is paid by the importer, provided that the imported goods are not brought to an excisable goods warehouse. The applicable tax base is the tax base of goods produced or imported in Lithuania.

J. Tax on real estate

Lithuanian tax authorities expect legal and natural persons to pay more than LTL 260 million on immovable property, which had to be declared by February 1, 2010. According to the Law on Real Estate, if real estate is used by individuals for business or individual activities (with several exceptions) or is transferred to legal persons for longer than one month, it is subject to a 0.3 to 1 percent real estate tax calculated on the value of the real estate. The council of the municipality or territory where the buildings and structures are located will determine the exact tax rate. Lithuanian and foreign entities owning buildings and structures in Lithuania are required to pay real estate tax. The rate remains unchanged at 0.3 to 1 percent of the taxable value of buildings and structures. The real estate tax return should be submitted to the state tax authorities within one month after the date of acquisition of the real estate. Legal entities (as opposed to individuals) should pay advance installments on a quarterly basis. Both individuals and legal entities should provide an annual real estate tax return to the state tax authorities by February 1 of the following year.

II. System of tax payments in Lithuania

A. Deferred payments of tax

Taxpayers are entitled to defer the payment of certain taxes for a period of one month to one year. Unpaid taxes are subject to a late payment fee. Late payment amounts however do not exceed the original debt amount.

B. Penalties

The amount of tax penalties imposed depends on the type and period of non-compliance. Late filing of tax returns triggers penalties of no more than LTL 500 for the first violation. The second violation results in an increased penalty of up to LTL 1,000. In the event of tax evasion, the penalty is LTL 2,000 to LTL 4,000 if no criminal charges are filed.

C. Voluntary rectifications of tax declarations

A taxpayer is allowed to make voluntary corrections to a tax return for period of five years after the payable term if an audit by the tax authorities has not commenced. This cancels any penalties pending for non-compliance. The taxpayer retains the right to apply for a voluntary correction to the tax return if an audit has commenced, but in that case, the tax authorities have the right to deny the application.

D. Appeals process

All decisions by the tax authorities may be appealed to the tax administrator, Tax Litigation Commission, and tax court. Decisions of the tax administrator may be appealed to the Tax Litigation Commission within 20 days of receipt of the tax administrator's decision.

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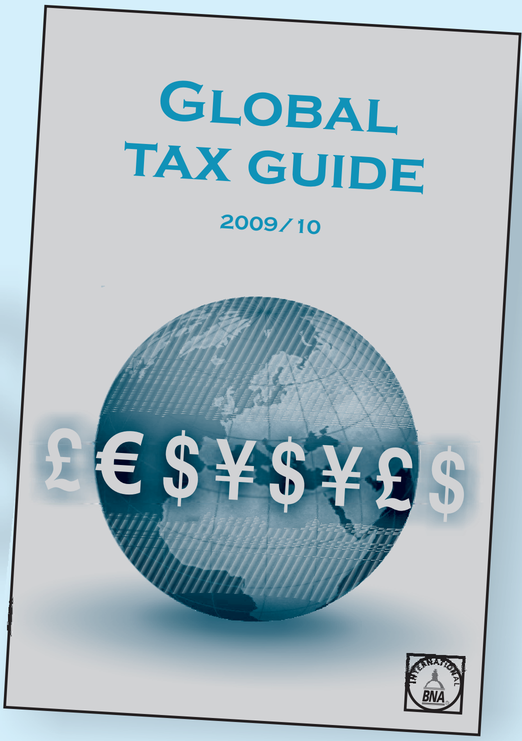

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In Brief

GERMANY

European Commission attacks German anti-abuse provision on withholding tax relief

Over the past few years German tax law has increasingly been influenced not only by German legislative and judicial forces / authorities but also by European institutions, such as the European Court of Justice and the European Commission.

With its recent request in March this year, the European Commission moved forward with the second step of the formal infringement procedures against Germany concerning the anti-abuse provisions on withholding tax relief affecting EU holding companies specifically.

In principle Double Tax Treaties, the EU Parent-Subsidiary-Directive as well as the EU Interest-and-Royalty-Directive provide for the reduction or even exemption from withholding taxes on, for example, dividend payments by German companies to their foreign corporate (intermediate) shareholder. The Directives allow the individual member countries a certain amount of tolerance with regard to the application.

The current national regulations applicable for Germany deny withholding tax benefits to a non-resident (intermediate) company if any of the following conditions (substance requirements) are met:

- There is no economic or other relevant reason to establish the foreign company;
- The foreign company does not earn more than 10 percent of its gross income from its own economic activity; or
- The foreign company has no adequate business premises for its activities.

The German legislator aims to prevent foreign companies from choosing structures that mean they benefit from favourable treaty provisions only, rather than choosing structures for business considerations. Germany introduced the second condition stated above in 2007. Thus, in addition to adequate premises and a non-tax reason for the interposition of the foreign company, German law requires that more than 10 percent of its gross income must be earned from the foreign company's own business. Furthermore, to be eligible for withholding tax benefits businesses must not meet any of the conditions stipulated above.

The international tax community has already reacted to the introduction of this legislation. The various substance requirements and economic or business rationale of using holding companies has already impacted the use of intermediary holding companies. Indeed, international tax planning efforts concerning German investments have increased in recent years and the discrimination of foreign companies adds an element of uncertainty for foreign investors who want to invest into Germany.

In its request the European Commission now concludes that the requirement for economic activity is disproportionate in its typical application that the proof of the contrary is not possible to the foreign company. With this condition Germany did eventually exceed what was necessary to meet its objective of preventing tax avoidance. EC law and related European case law require from its member states such as Germany to review each individual case rather than applying general standardised requirements. Initially Germany was granted a two month period until mid-May 2010 to respond which we understand has not been taken up, meaning the Commission may bring this matter to the European Court of Justice.

Comments

The German anti-abuse provisions concerning withholding tax benefits on dividends and licence payments were heavily criticised when first introduced as they significantly increased tax planning efforts and even presented an element of uncertainty for foreign investors to invest in Germany.

Taxpayers being denied withholding tax reliefs or withholding tax refunds based on this provision should take the appropriate steps to keep their cases open for the time being to be in a position to reclaim withholding tax relief in case of an amendment of the German anti-abuse regulations.

The European Commission in particular criticises a lack of proof of the contrary in the German anti-abuse provisions. Thus, in principle, Germany could remedy the concerns of the European Commission by introducing the possibility for foreign companies not meeting the substance requirements to provide proof of the contrary. However, as of now no official reaction from Germany has been put forward. It would seem they would rather await the reaction from the European Commission.

(*Article first published on Director of Finance, September 2010, and in Taxand's Take, Taxand's global newsletter for multinationals.*)

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LATVIA

Latvia's "Micro-Enterprise Tax"

In order to stimulate development of small and medium sized enterprises in Latvia, the country's Parliament adopted on August 9, 2010, a new law on "Micro-Enterprise Tax". The law entered into force on September 1, 2010. During the readings in Parliament of Latvia, the law experienced several changes that also are described below.

The new law provides a preferential tax for micro-enterprises, i.e. individual merchants, individual enterprises, farms, other natural persons that are registered as performers of economic activities, or limited liability companies that have chosen to adopt the micro-enterprise status and who, under the law, may make only one tax payment.

The law enables small businesses to pay flat-rate tax of 9 percent on their turnover. The present rate is considerably lower than it was initially envisaged and was moved forward by the government (i.e. 20 percent). The tax shall be paid four times a year on the turnover of each quarter.

The flat-rate tax of 9 percent includes the following tax payments:

- State social insurance mandatory contributions, personal income tax and entrepreneur risk state fee for employees of the micro-enterprise;
- Enterprise income tax if the micro-enterprise conforms to the features of enterprise income tax payer; and
- Personal income tax of owner of the micro-enterprise for earnings of micro-enterprise economic activity.

In order to qualify as a micro-enterprise for tax purposes, the following conditions must be satisfied:

- The member of the enterprise may only be natural persons, who at the same time are members of the board;
- The turnover of such enterprise within a calendar year shall not exceed USD 1.28,440;
- The total number of employees on the payroll of such enterprise does not exceed five, not including those on the leave;
- The income of any given employee does not exceed USD 910 per month; and
- The employees of such enterprise have agreed to be employed by micro-enterprise in their respective labour agreement.

An enterprise that meets these conditions must submit an application to the State Revenue Service until December 15 of the pre-taxation year, and it becomes a micro-enterprise tax payer from January 1 of the following year. The law allows the micro-enterprise to revert back to usual tax regime only after the respective taxation period is over. There are no additional restrictions to re-choose the micro-enterprise tax regime later, if the above mentioned conditions are satisfied.

In case a micro-enterprise employs more than five employees or their income exceeds the limit, or turnover of the micro-enterprise exceeds the limit, additional tax is levied.

For each additional employee over and above the maximum prescribed number of five employees, two additional percentage points are added to the tax rate. If the income of any employee exceeds the maximum income amount, an increased tax rate of an amount of 20 percent is leviable on the excess amount additionally over and above the tax rate of 9 percent. For micro-enterprises, whose turnover exceeds the maximum eligible turnover, a tax rate of 20 percent is applied on the amount over and above the threshold.

All the employees have to be employed in accordance with written labour agreement. In case the employer has not informed the employees that they are employed by a micro-enterprise, the employer is liable for damages so incurred by the employees. This is due to the fact that employees of micro-enterprise are less socially protected than others because of reduced social contributions and eventual social benefits in case of unemployment or sickness.

Finally, the most important differences from the initial draft law should be noted. As already mentioned above, the initial flat-tax rate submitted for approval of the Parliament was 20 percent. The tax rate after discussions in the Parliament was effectively reduced to 9 percent. There are also restrictions removed on the rights of choice of micro-enterprise to re-choose micro-enterprise tax regime after reverting back to original tax regime. The first draft law envisaged an obligation to let the original tax regime stay in force for five years after reverting back to original tax regime before re-choosing micro-enterprise tax regime. The last difference to be noted is the issue of employment of relatives and spouses. The first draft allowed employment of relatives and spouses without any labour agreement. Now, according to the final text of the law, all employees have to be employed in accordance with written labour agreement and also be subject to the maximum prescribed number of five employees.

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ISSN 1754-1646

LITHUANIA

Thin capitalisation rules in Lithuania

In 2009, Lithuania and other Baltic countries faced a difficult challenge combating financial instability. Lithuania increased most taxes to offset economic losses and bolster public finances in 2008-2009. However, 2010 has started with ease, as the tax burden has decreased. As a result, Lithuania remains attractive to foreign investors because of favourable tax planning opportunities.

Notably, the parties to the various transactions are expected to apply the transfer pricing principles, which are fully applied in Lithuania. In order that controlling persons do not breach the market price principle and the interest rates do not turn up to be dividends, the Lithuanian government introduced thin capitalisation rules, detailing the amount from which interest can be deducted and situations when it cannot be deducted.

Detailed below are the rules of transfer pricing and thin capitalisation.

Market price and economic benefit

What is "market price"?

Transfer pricing in Lithuania is laid down in the laws and fully applied in practice. Its definition is laid down in the laws on Value Added Tax and Corporate tax law. Therefore, open market value corresponds to the amount of consideration which a purchaser would have to pay for the goods or services to a supplier thereof at arm's length where each one of them is seeking maximum economic benefit for himself.

In the cases where the tax administrator has grounds to suspect that the taxable amount of the supplied good or service has been artificially changed, it will have the right to calculate the taxable amount. The taxable amount of the supplied good or service may be considered artificially reduced or increased in the case where, upon giving due consideration to all conditions of the transaction, the taxable amount does not correspond to the open market value of the good or service.

The taxable amount is calculated, on the decision of the tax administrator, on the basis of the open market value determined in accordance with the methods approved by the Government of the Republic of Lithuania or an institution authorised by it. It is not applicable to the supply of goods or services effected for a consideration fixed by state or municipal institutions and agencies or in the international agreements of the Republic of Lithuania.

Law on Corporate tax sets the definition for the actual market price which is considered as the amount for which assets may be exchanged or mutual obligations settled between willing independent buyers or sellers in a direct transaction.

Adjustment of transaction or economic operation value and revaluation of income or benefits

Entities must recognise the amount which is in line with the actual market price of a transaction or economic operation as income from such transaction or economic operation and they must recognise the total amount of costs incurred during a transaction or economic operation which is in line with the actual market price of such transaction or economic operation, as allowable deductions or limited allowable deductions.

Where the conditions created or prescribed by mutual transactions or economic operations between associated persons are other than those created or prescribed by a mutual transaction or economic operation between non-associated persons, any profit (income) that would be attributed, if no such conditions existed, to one of such persons, but due to such conditions is not attributed to him, may be included in the income of that person and taxed accordingly.

Thin capitalisation rules

Notably, all transactions in Lithuania should be in accordance with market value.

The Rules for the Requalification of Income or Payments approved by Lithuanian Government define the cases when income or payments must be requalified. It is important to note the qualification of interest on the Controlled Lent Capital.

Laws prescribe that the share of capital lent for remuneration to the Lithuanian entity by the controlling lender(s), which is in excess of the ratio 4:1 between such lent capital for remuneration and fixed capital, is qualified as controlled lent capital.

The ratio between lent capital for remuneration and fixed capital set above is calculated as of the last day of the taxable period of the Lithuanian entity.

If lent capital is denominated in foreign currency, the ratio between such lent capital and fixed capital is calculated after conversion to litas (Lithuanian currency) by applying the official currency exchange rate announced by the Bank of Lithuania as on the last day of the taxable period.

Interest payable on the use of controlled lent capital shall be considered unrelated with the earning of income and shall not be deductible, for the purpose of calculating taxable profit of the controlled Lithuanian entity, from income of the Lithuanian entity. Currency exchange losses related to controlled lent capital are not deductible from income of the Lithuanian entity.

The above rule will not be applied if the Lithuanian entity proves that an equivalent loan might be taken on the same conditions between independent (unrelated) persons. Such proofs are normally presented in accordance to the Lithuanian Bank statistical data, providing interest rates and its market value of every month. The provisions of those rules will not apply to financial institutions providing financial lease (leasing) services.

To present with an example, a company's fixed capital is EUR 150 and a loan of EUR 700 payable to its controlling company. In this case if the 4:1 principle is applied, EUR 600 (150x4= 600) is the sum to which the company may attribute interest, and this interest enjoys the right of possible deductions.

The balance EUR 100 (700-600) (the loan minus the sum to which the company may attribute interest equals to 100) is the sum, the interest on which will be non-deductible. Therefore, the interest from EUR 100 will not be deductible and from the balance EUR 600, it will be deductible.

It is important to note that fixed capital in accordance to local legislation is the equity of a Lithuanian taxable entity as of the last day of the taxable period, excluding the financial result (profit/loss) of the taxable period concerned. For the purpose of calculating fixed capital, equity of the Lithuanian entity shall not include the revaluation result of assets transferred to it by the controlling lender, if such assets have been used by that Lithuanian entity for less than two years.

Regarding qualification of interest and rent payments, it shall be noted that interest payments related to profit, income or similar performance indicators (e.g. sales) of the Lithuanian entity and interest payable under debt-claims entitling the lender to exchange its right to interest with the right to the borrower's profit or a part thereof, and rent payments related to profit, income or similar performance indicators of the Lithuanian entity, shall be qualified as unrelated to the earning of income and shall not be deductible, for the purpose of calculating taxable profit of the controlled Lithuanian entity, from income of the Lithuanian entity.

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ECJ in brief

EUROPEAN UNION

Dutch real estate companies in view of European law

Real estate transfer tax on shares possibly contrary to the EU Capital Duty Directive

Several EU Member States impose a real estate transfer tax on the acquisition of existing or newly issued shares in a 'real estate company'. A 'real estate company' is a company the assets of which consist mainly, directly or indirectly, of real estate.

Recently, two cases, both regarding the Spanish real estate transfer tax, have been opened. First, the European Commission has started an infringement procedure, formally requesting Spain to change its tax provisions insofar as they impose a real estate transfer tax on the issuing of shares by a 'real estate company'. Furthermore, a preliminary question regarding real estate transfer tax on share deals has been referred to the ECJ by the Spanish Supreme Court in the case of *Inmogolf*. First, the European Commission has formally requested ('reasoned opinion' according to Article 258 TFEU) Spain to change its tax provisions related to the transfer of securities. The Commission considers that the imposition of a transfer tax on certain contributions of capital, in addition to capital duty, is contrary to the Capital Duty Directive (2008/7/EC).

Council Directive 2008/7/EC allows Member States to levy capital duty on contributions of capital but the tax rate may not, in any event, exceed 1 percent of the capital increase and, according to Article 5 of the Directive, Member States may not levy any other tax on such an increase. The Commission considers that the Spanish legislation at issue is not in conformity with Article 5 of Council Directive 2008/7/EC as it provides for another tax to be levied in addition to capital duty on certain contributions of capital that fall within the scope of the Directive.

Second, a preliminary question regarding real estate transfer tax on share deals has been referred by the Spanish Supreme Court to the ECJ. The Supreme Court is asking the following questions:

- Whether Directive 2008/7/EC allows Member States to automatically impose a real estate transfer tax on share deals without the need to demonstrate that the transaction is tax driven? and
- Whether the Directive allows a real estate transfer tax on the acquisition of the majority of shares in a 'real estate company' in a situation which concerns a normal operating company, the real property of which cannot be disassociated from their economic activities?

Please note that the Dutch version of this article is 'De onroerendezaaklichamen van art. 4 Wet BvR in Europees perspectief', Nederlands Tijdschrift voor Fiscaal Recht (NTFR) 2010/1486 of July 1, 2010.

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"Cultural Support Duty": Germany's tax on tourists in disharmony with VAT Act

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Determined to generate additional revenue, the German state of North Rhine-Westphalia will soon pass approval on Cologne's proposed tax on hotel overnight stays in the city and the so-called "bed tax" (*Bettensteuer*), aimed at yielding hundreds of millions for the local municipality, has received full support from the Cologne City Council. The author looks at the probable difficulties in its chargeability alongside VAT and its incompatibility with the EU law.

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I. Background

In common with many other European countries, Germany has a long tradition of resort fees charged by the local authorities in tourist regions. The justification has usually been the need to finance the additional community services needed by the tourist population during the season. This justification goes hand in hand with the hope that holidaymakers will be in no mood to trifle when it comes to paying their hotel bills. Unsurprisingly, other local authorities have come to see the budget – and political – benefits of taxing visitors unable to vote at local council elections. Since most larger towns in Germany are not immediately recognisable as tourist or health resorts, another name for a charge on visitors is called for. For the moment, there seems to be a consensus on "Cultural Support Duty" – presumably because every council regards itself as supportive of culture, and perhaps also because every council can show at least some expenditure on cultural development, even if only in a rather broad sense of the term.

 09/10 TPETS ISSN 1754-1646

Weimar led the way with a very modest cultural support duty under a local bye-law passed in 2005. The rates are EUR1 per room and night for hotels with a capacity of up to 49 rooms and EUR2 for larger establishments. Unoccupied rooms are not taxed.

Various other towns have, in the meantime, followed Weimar's lead. Bingen on the Rhine has passed a rather similar bye-law to take effect at the beginning of 2011. The nightly rates per guest are EUR1 for accommodation with a net price of up to EUR30, EUR2 where the price tag is up to EUR100 and EUR3 where the net charge is higher. However, Bingen will only tax the first four nights of any stay in one place; thus the maximum amount payable by a guest will be EUR12 unless he changes hotels during his stay.

II. Cologne's "Bed Tax"

Cologne also intends to tax hotel accommodation with a cultural support duty. The bye-law is still in draft, pending approval from the provincial government of North Rhine-Westphalia. The Cologne duty is more controversial than the levies in either Weimar or Bingen, partly because of the heavy incidence of business travel – Cologne is a major commercial centre as well as hosting the largest trade fair in North-West Germany – and partly because the city has chosen an *ad valorem* rate of 5 percent of the accommodation charge to the guest without upper limit, whether by amount or length of stay. The Cologne charge also extends to accommodation on board a ship anchoring or mooring during the night. The body collecting the mooring fee will be responsible for paying the tax to city tax office. If the accommodation is not charged separately – i.e. it is included in the cost of the cruise or voyage – its price will be assumed at EUR100 per passenger and night. Potentially, this is significant, as the Rhine at Cologne is part of an international waterway (the Rhine/Main/Danube complex) linking Rotterdam with the Black Sea.

III. Basis of charge: reconciliation with VAT concept

In Cologne, as in Bingen, the tax is to be collected from the provider of the accommodation. The Cologne bye-law refers to him as the taxpayer. Neither bye-law makes any provision for passing on the charge to the guest, although the official explanation to the Cologne resolution suggests that the city authorities expect this to happen in most cases. Unfortunately, Cologne has made it impossible for the hotel to recharge openly on the invoice, thanks to a clash of concept with the VAT Act. The bye-law bases the duty on the room price including VAT (7 percent), whilst the VAT Act defines the basis for VAT as the total amount spent by the customer to acquire the supply, less the VAT. Thus the duty is to be included in the basis for VAT. Mathematically, one could only satisfy both demands by levying the duty at 5.47 percent and VAT at 9.38 percent of the accommodation price before both taxes. However, there is no legal basis for invoicing either at any rate other than 5 percent or 7 percent respectively, and any attempt to do so would be bound to fail before the courts. Spokespersons from the Cologne town council have suggested the hotel should solve this dilemma by invoicing the room price, adding the VAT, and then adding 5 percent of the sum to come to an invoice grand total. This advice sounds a simple solution; however it contradicts the VAT Act and leads directly to an underpayment of VAT. The VAT rules are not at the disposition of the city authorities and are not to be interpreted by city officials. The tax auditors are most certainly not bound by any city edicts and it will be no defence for a hotel faced with an additional VAT demand to maintain that it had acted in good faith in following a statement from the council. The risk remains with the hotel, which will, if only for purely practical reasons, be unable to recover the amount from its guests in most cases.

IV. Can a local authority raise a surcharge on VAT being a national tax?

Basing the duty on the room price including VAT raises a number of other, no less controversial, legal issues. First and foremost there is the question as to the entitlement of a local authority to raise a surcharge on a national tax. Even if Cologne can be seen as having this authority, any charge based on a VAT amount cannot have consequences different from those of its own basis. This means that any business bearing a hotel charge should have the same right to recover the cultural support duty on the VAT as it would in respect of the VAT itself. However, it should be easy enough for the Cologne council to resolve these and other problems of principle with a simple amendment to the draft bye-law. Duty at 5.35 percent on the accommodation charge before VAT yields the same tax revenue as 5 percent on the VAT-inclusive total.

V. Redressals for guests

The Cologne bye-law carries a clause allowing a guest who has been "wrongfully" charged with duty to apply to the city authorities for a refund. At first sight, this appears to be out of place, especially as there is no further provision for exemption or relief from duty in circumstances that a hotel could not apply directly (such as the provision for relief on the food element of a full-board price). This refund provision has, however, been explained as a service to hotels; an aggrieved guest can turn to the city authorities for redress, sparing the hotel from the need to explain and interpret the duty. Rather obviously, the value of this service leaves something to be desired. It would be natural for a guest with a query on his bill to turn to his contract partner, the hotel, for satisfaction. In any case, foreign guests are unlikely to be enthused with the idea of claiming a refund from city officials with whom they do not necessarily have a common language. Perhaps tellingly, the bye-law makes no provision for a refund by the city to the actual taxpayer, the hotel. In any event, the clause opens a second avenue of complaint to guests who feel justified in refusing to pay the duty – never a happy solution.

VI. "Wrongful" charge of duty

The gravity of this becomes apparent when one reflects that there is no indication in the bye-law as to what might be meant by a "wrongful" charge of duty to a guest. Indeed, the lack of any provision for re-charging could be taken to mean that that any charge is without a legal basis and therefore "wrongful", unless the guest explicitly agreed to accept the burden when booking his room. Without this agreement, he would seem to have the option of refusing to pay the duty demanded by the hotel, or turning to the city for a refund. Clearly, this is not the city's intent.

On the other hand, not every threatened attack on the duty is likely to prove well-founded. One body has suggested that business travellers should be exempt from a cultural support duty because they are not visiting Cologne in a cultural connection. This assertion conveniently ignores the tenet that payment of a tax does not give the payer any specific right to services financed from its revenue – the basic distinction of a tax from a fee – quite apart from the fact that it is manifestly inappropriate. Many business people visiting Cologne would not wish to feel excluded from a visit to the theatre on their free evening, and many non-business people stay the night in Cologne for railway timetable and other reasons of no cultural import. In any case the only connection of the duty with culture lies in its name. Nothing in the bye-law prescribes any particular purpose to which the proceeds should be applied.

VII. Is the cultural support duty in line with EU law?

It has also been suggested that the duty falls foul of the EU prohibition on a second charge to turnover tax after VAT – Art. 401 of the VAT Directive (2006/112/EC) and Art. 3 of Directive 92/12/EEC on the general arrangements for products subject to excise duty. This suggestion has, however, been conclusively refuted by the ECJ in a directly comparable case of a Frankfurt city tax of 10 percent on the price of alcoholic drinks served for consumption on the premises. The ECJ held the double charge prohibition to be general and not to apply to specific charges for certain goods and services within the context of overall turnover. If nothing else, the hotel will also offer breakfast outside the scope of the duty. The ECJ case reference is C-491/03 *Hermann*, judgment of March 10, 2005.

VIII. Comments

Various trade associations are looking critically at the Cologne proposal. Ultimately, the cultural support duty is either a cost for the hotel, or a burden on the customer. If the latter, the hotel can expect the same effect on room sales that would come from a 5 percent rise in room rates. In 2005, the trade took no action against the Weimar duty – despite misgivings at the national level – on the insistence of the local hotels, who preferred to accept the low rates in the bye-law, rather than fight for the principle. An additional 5 percent charge without upper limit is, however, not immaterial for the hotel trade in a major fair city, with its over-supply of hotel accommodation when a fair is not being held. Although attacks on the bye-law on basic points of principle are unlikely to be successful, bad drafting – and possibly muddled thinking – have led to a less than perfect example of local legislation. If it is not rewritten, it is likely to founder in court, at least in major respects. This would be a severe disappointment for the many towns up and down the country that are looking to follow the Cologne example.

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