ec TAX REVIEW 2006-1

2006
VOLUME 15
ISSUE 1

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KLUWER/ LUCHTERHAND

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EC TAX REVIEW

VOLUME 15
2006-1

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SUBSCRIPTION ENQUIRIES
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ISSN 0928-2750

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EC Tax Review is available to *Intertax* subscribers only and is published quarterly by Kluwer Law International Ltd., 3rd Floor, 241 Borough High Street, London SE1 1GB, United Kingdom.
US Mailing Agent: Mercury Airfreight International Ltd., 365 Blair Road, Avenel, NJ 07001.
Post masters: Please send all address corrections to: EC Tax Review, c/o Mercury Airfreight International Ltd., 365 Blair Road, Avenel, NJ 07001, USA.
Distribution for the USA and Canada, periodicals second-class postage paid at Rahway, N.J.
Distribution for the rest of the world, Kluwer Law International, c/o Extenza-Turpin, Stratton Business Park, Pegasus Drive, Biggleswade, Bedfordshire, SG18 8TQ, United Kingdom, Fax: +44 (0) 1767 601640

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Printed in The Netherlands.

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Legislation

SPAIN

The Resolution 2/2005 from the Directorate-General of Taxes of the Ministry of the Economy and Finance of Spain:[1] new application of the Value Added Tax Law, about the proportion rule, when subsidies are perceived, in the light of the recent judgment of the Court in the case C-204/03, 6 October 2005, and the effects in time of the judgment in the Spanish domestic law

1. Introduction

The recent Court decision of 6 October 2005 (C-204/03) rejects the interpretation of the Sixth Directive[2] the Spanish Government has adopted in their domestic law, specifically when connected to the cases in which the proportion rules (limitation of the right to deduct) shall apply when a taxable person receives subsidies which do not form part of the taxable amount. Consequently, the Directorate-General of Taxes has laid down a Resolution establishing the new application of the domestic law according to the decision of the Court.

2. Community and domestic legislation on subsidies and the proportion rule

Article 17(2) of the Sixth Directive sets out the principle of the right to deduct VAT.

'The latter concerns input tax on the goods and services used by taxable persons for the needs of their taxed transactions'.[3]

Article 17(5) of the Directive regulates the scope of the proportion rule.

> 'As regards goods and services to be used by a taxable person both for transactions covered by paragraphs 2 and 3, in respect of which value added tax is deductible, and for transactions in respect of which value added tax is not deductible, only such proportion of the value added tax shall be deductible as is attributable to the former transactions. This proportion shall be determined, in accordance with Article 19, for all the transactions carried out by the taxable person.'

Article 19(1) establishes the criteria which determine the calculation of the deductible proportion.

> 'The proportion deductible under the first subparagraph of Article 17(5) shall be made up of a fraction having: as numerator ...; as denominator .... The Member States may also include in the denominator the amount of subsidies, other than those specified in Article 11A(1)(a).'

As we see, Art. 19 states - regarding the subsidies received which do not form part of the taxable amount - that the Member States are entitled to include or exclude them from the calculations of the deductible proportion.

The Spanish law adapted its legislation to the Community law[4] regulating the inclusion of the subsidies which do not form part of the taxable amount in the calculations of the deductible proportion. First, according to Art. 102 of the Value Added Tax Law, the scope of the proportion rule affects both mixed taxable persons and fully taxable persons when they receive subsidies which do not form part of the taxable amount.

As the Court declares, Art. 102, read in conjunction with the first sentence of the provisions of Art. 104 of that same law (in which are established the criteria for the calculations of the proportion rule when they are capital subsidies) states a general rule:

> 'The subsidies to finance the trade or business of a taxable person, which do not form part of the basis of VAT assessment, are taken into account in the calculation of the deductible proportion in so far as they are part of the denominator of the portion which that proportion results from.'[5]

This general rule consists not only of mixed taxable persons (taxable persons who use the goods and services obtained as inputs to carry out, at the same time, transactions in respect of which VAT is deductible and other transactions of a similar nature in respect of which it is not), but also fully taxable persons (taxable persons who use goods and services exclusively to carry out transactions in respect of which VAT is deductible).

Secondly, the second paragraph of Art. 104(2)(2) of the VAT Law states that:

1 Resolution 2/2005, 14 November, from the Directorate-General of Taxes, about the effects on the right to deduct VAT of the subsidies which are not directly linked to the price of the supplies since judgment of the Court, 6 October 2005. BOE (State Official Gazette), no. 279, 22 November 2005, pp. 38044 to 38047.

2 Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment (OJ, 1977, L 145, p. 1), as amended by Council Directive 95/7/EC of 10 April 1995 (OJ, 1995, L 102, p. 18; 'the Sixth Directive').

3 Paragraph 21.

4 Law no. 66/1997 of 30 December 1997 (BOE no. 313 of 31 December 1997, p. 38517) amended some provisions of Law no. 37/1992 of 28 December 1992 on value added tax (BOE no. 312 of 29 December 1992, p. 44247).

5 Paragraph 13.

> 'when capital subsidies are granted in order to fund the purchase of certain goods or services, acquired in connection with transactions that are taxable and not exempted from VAT (mixed taxable persons), will reduce exclusively the amount of the deduction of VAT borne or paid in respect of those transactions, to the precise extent to which they have contributed to their funding.'

As the Court declares, the second sentence of the provisions of Art. 104 establishes a special rule. When subsidies are exclusively granted in order to fund the purchase of certain goods or services, and are received by fully taxable persons (transactions that are taxable and not exempted from VAT), these subsidies will be subject to a particular calculation of their deductible proportion.

> 'Consequently, in the case of a subsidy amounting, for example, to 20% of the purchase price of a good or service, the right to deduct the VAT specifically imposed on that good or service is reduced by 20%.'[6]

3. Judgment of the Court: failure to fulfil Articles 17 and 19 of the Sixth VAT Directive

According to the interpretation of the Court on the content of Arts. 17 and 19 of the Sixth Directive (paras. 21 to 25), the proportion rule is only applicable when the taxable person is a mixed taxable person (taxable persons who use the goods and services obtained as inputs to carry out, at the same time, transactions in respect of which VAT is deductible and other transactions of a similar nature in respect of which it is not).[7] The following appreciations of the Court support this issue:

> 'Article 17(5) of the Directive sets out the scope of the proportion rule and Article 19 of the same Directive prescribes the calculation of that proportion rule. Thus, the content of Article 19 (calculation of the deductible proportion) is "wholly related to" Article 17(5) (scope of the deductible proportion).'[8]

As a consequence, what is established on subsidies in Art. 19, must be read in the light of Art. 17(5). This entitlement on subsidies for the Member States (Art. 19) is not an exception applicable to both mixed and fully taxable persons, but an authorization to limit the right to deduct when the mentioned subsidies (which do not form part of the taxable base) are only obtained by mixed taxable persons.

Moreover, the Court has pointed out that, the deductible proportion regulated in Art. 17(5) of the Directive, is a limitation of the right to deduct. This limitation affects the level of the tax burden and must be applied in a similar manner to all Member States. Consequently, the Member States can only regulate exceptions to the right to deduct when they are expressly provided for in the Sixth Directive.[9]

On the contrary, according to the interpretation of subsidies by the Spanish Government, Art. 19 is an exception of the scope of Art. 17(5) of that Directive. In this light, they argue that Art. 19 of the Directive does not simply constitute a rule for calculating the mentioned proportion rule (Art. 17(5) of the same Directive), but also an exception to the rule laid down in Art. 17(5) (regarding mixed taxable persons) by allowing restrictions of the right to deduct of fully taxable persons, when these receive subsidies, which do not form part of the taxable amount. With these arguments the Spanish Government highlights that Art. 102 of the VAT law introduces the exception that had already been established in Art. 19 of the Sixth Directive.[10]

Although the Court seems to accept that the interpretation of Art. 19 of the Sixth Directive from the Spanish Government is conform to the neutrality principle, the Court states expressly that Member States are required to apply the Sixth Directive even if they consider it to be less than perfect. In this sense, the Court makes reference to the Case C-388/98 *Commission v Netherlands* [2001] (ECR I-8265) in which we can see this finding. In paras. 55 and 56 of this case, it is indicated that 'even if the interpretation put forward by certain Member States better served certain aims of the Sixth Directive, such as fiscal neutrality, the Member States may not disregard the provisions expressly laid down in that directive' by introducing, in this case, limitations of the right to deduct other than those laid down in Arts. 17 and 19 of that Directive.[11]

In the light of these findings, the Court concludes the following in this case.

The General Rule laid down in Art. 102 of the Law no. 37/1992 introduces a restriction which goes beyond the one expressly provided for in Arts. 17(5) and 19 of the Sixth Directive and infringes the provisions of the Directive by extending the restriction of the right to deduct to fully taxable persons.[12]

The Special Rule set out in the Law introduces a mechanism for limiting the right to deduct which is not provided in any provision of the Sixth Directive. This mechanism, as a restriction of the right to deduct adopted exclusively by a Member State, does not conform to the Directive.[13]

On those grounds, the Court holds that, the Kingdom of Spain has failed to fulfil its obligations under Community law (and, in particular, Arts. 17(2) and (5) and 19 of the Sixth Directive) by providing for a deductible proportion of VAT for fully taxable persons (who carry out only taxable transactions) as

6 Paragraph 14.
7 Paragraph 22.
8 See para. 24.
9 See para. 23 of the Sentence in which reference is made to *Commission v France*, 50/87 [1988] ECR 4797, para. 17; *BP Supergas*, C-62/93 [1995] ECR I-1883, para. 18, and *Metropol and Stadler*, C-409/99 [2002] ECR I-81, para. 42).
10 See para. 17. *Ad exemplum* about the interpretation on Arts. 102 and 104 of VAT by the State Administrative Economic (TEAC) see Resolutions of the TEAC numbers: 4045/2002 (24/11/2004), no. 7617/2001 (28/07/2004), no. 5321/2001 (15/07/2004), no. 3613/2001 (11/02/2004), no. 3215/2002 (18/06/2003), no. 4379/2000 (06/06/2001), no. 442/2001 (18/07/01).
11 See para. 28.
12 See para. 26.
13 See para. 27.

a general rule, and by laying down a special rule which limits the right to deduct VAT on the purchase of goods and services which are subsidized.[14]

4. Resolution 2/2005, 14 November, from the Directorate-General of Taxes, about the effects on the right to deduct VAT of the subsidies which are not directly linked to the price of the supplies according to the judgment of the Court, 6 October 2005[15]

Resolution 2/2005 regulates two essential aspects: on the one hand, the Resolution states the new interpretation and application of Arts. 102 and 104 of Law 37/1992. On the other hand, it also includes the temporal effects of the judgment in relation to the beneficiary taxable persons. In this sense, three legal consequences (on interpretation of Arts. 102 to 104 and temporal effects) are of particular interest.

4.1. The scope of the deductible proportion is restricted to mixed taxable persons

The 'mixed taxable person' will, in this context, be the taxable person who uses the goods and services obtained as inputs to carry out, at the same time, transactions in respect of which VAT is deductible and other transactions of a similar nature in respect of which it is not. In this sense, in the Spanish tax system, when the taxable person carries out exempted transactions according to Art. 20(1) of Law 37/1992, which do not confer the right to deduct, they will be considered 'mixed taxable persons'. As a consequence, in these cases the proportion rule is applicable.

As an exception, when VAT exempt transactions are related to property or finance, and are not common practice for the businessman or professional, the proportion rule will not be applied (Art. 104(3) of VAT Law). Only in cases where the proportion rule applies will general subsidies, which do not form part of the taxable amount, be included in the denominator of the proportion rule.

4.2. Capital subsidies specifically granted in order to fund the purchase of certain goods or services will have the same tax treatment in the calculation of the proportional deduction than general subsidies intended to fund the economic activity of the taxable person

The particular mechanism for limiting the right to deduct in Art. 104(2)(2), second paragraph ('... will reduce exclusively the amount of the deduction of VAT borne or paid in respect of those transactions, to the precise extent to which they have contributed to their funding') does not apply.

4.3. The right to refund VAT to the taxable persons benefited from the judgment: does the Spanish Resolution 2/2005 conform to the effects in time described in the judgment?

According to paras. 29 and 30 of the Court's judgment, the Court expressly refuses the possibility, requested by the Spanish Government, to restrict the effects in time of the present judgment. The Court noted that 'it is only exceptionally that the Court may, in application of the general principle of legal certainty inherent in the Community legal order, be moved to decide on such a restriction'.

'In that regard, and as pointed out by the Advocate General in paragraph 24 of his Opinion, it must be established that the State authorities were prompted to adopt legislation or conduct contrary to Community law because of objective and significant uncertainty regarding the implications of the community provisions concerned (see, to that effect, Case C-359/97 *Commission v United Kingdom* [2000] ECR I-6355, paragraph 92). However, there was no such uncertainty in this instance. It is thus not necessary to restrict the effects in time of the present judgment.'

In Resolution 2/2005, the Spanish Directorate-General of Taxes prescribes that the present judgment has a 'limited retroactive effect in time'[16] according to the domestic procedure rules. In this sense, in application of the General Taxation Law 58/2003,[17] which includes the procedure rules, the Resolution explains three possible situations which may affect the taxable person benefited from the present judgment.

1. Cases in which exist an Administrative Assessment of Tax Authorities and the legal procedure has totally expired (situations of *res judicata*, prescription, lapse of time or similar effects - all of them, definitive situations). In these cases, taxable persons do not have the right to refund VAT, according to Art. 221(3) of the General Tax Law.[18] In these cases, there are not effects in time. The judgment will not apply.
2. Cases in which exist an Administrative Assessment of Tax Authorities and the legal procedure has not finished. In these cases, it will depend on the final resolution. Taxable persons involved in these procedures will only have to submit the present judgment in order to have their VAT refunded. Even though the Resolution does not expressly explain the effects in time in these cases, it is obvious that the right to refund VAT is backdated to 1998,[19] where the domestic rule on subsidies contrary to the Directive came into force. The effects in time of the judgment are not limited by the Spanish resolution in these cases.
3. In cases in which an Administrative Assessment does not exist, the demand to refund VAT will only be extendable to periods which are not lapsed time-barred (the last four years), according to Art. 66 of the General Taxation Law. In these situations, the effects in time of the judgment are

[14] See para. 31
[15] See n. 1 above.
[16] Resolution 2/2005, p. 38047 (see n. 1 above).
[17] BOE (State Official Gazette) no. 302, of 18 December 2003.
[18] General Taxation Law 58/2003.
[19] Law no. 66/1997 of 30 December 1997, BOE no. 313 of 31 December 1997, p. 38517.

not backdated to 1998, but are limited to the last four years. This is a restriction of the retroactivity of the judgment.

Consequently, in relation to the Resolution of the Spanish Directorate-General of Taxes, the effects in time are not always applicable. When the course of any administrative or judicial procedure has totally expired, taxable persons will not have the right to claim the refund of VAT. The effect in time will not apply (see cases mentioned in A above).

On the other hand, in cases in which the effects in time are applicable (because the right to claim the refund of VAT has not expired, according to Spanish rules), the retroactive effect in time can be different. In some situations, effects in time do not have limitations, as the Court expressively indicates in paras. 29 and 30 of the judgment (see B above). In the rest of the cases, effects are limited to the last four years (see C above).

In conclusion, the domestic law regulating the interpretation on retroactive effects of the judgment (Resolution of the Directorate-General of Taxes 2/2005) may be contrary to the judgment itself. The Court is unequivocal when rejecting any limitation of the retroactive effects of the judgment. In this respect, the judgment does not set out any exceptions in time for taxable persons. Should we consider this as another failure to fulfil one Community law by the Spanish law? In our opinion, in order to answer this question properly, it is necessary to look at the impact that the Spanish procedure rules (especially, on the effects of the domestic rules when the court states its illegality) are having in the fulfilment of the Community law.

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ITALY

The fiscal regime applicable in Italy to a trust

The Italian fiscal authorities issued a ruling, dated 28 September 2004, concerning both the tax treatment of an immovable property contribution into an *inter vivos* trust (i.e. a 'liberal' trust) and the tax treatment of the trust as such.

Such ruling was requested by a taxpayer whose intention was to set up a trust having as a main asset an immovable property. The trustee essentially had to take care of this good, preserving it well and renting it to thirds. Further, the settlor was also the final beneficiary of this trust.

The authorities observed that the trust was in line with the Hague Convention (of 1 July 1985) provisions and with the law governing the Trust (which was the Law of Jersey). Yet, since it was not apparent whether the settlor was different in respect to the trustee and to the guardian, the authorities could not express their position upon the real existence of a trust. In fact, the Italian financial authorities in a previous decision took the view that where the management of a trust is attributable to the settlor the trust is '*tamquam non esset*', that is, non-existing (see Resolution no. 8/E of 17 January 2003). Notwithstanding that, they shed some light on the following fiscal profiles.

The tax treatment of an immovable property contribution into a trust

According to the tax authorities, the contribution of an immovable property into the trust at issue could not be regarded as a 'gift' in so far as the setting up of this trust met the wishes of the settlor to segregate the immovable property and to enhance its value. Therefore, the contribution of the immovable could not be qualified as an 'indirect gift' (that is an attribution of the good at issue to the trustee in the beneficiaries interest) and, consequently, the fiscal regime provided for the gift could not be applied.

In conclusion, the applicable tax should only be the registration tax at a rate of 3 per cent, that is the rate provided for any residual transfer of property different from the standardized deed of property transfer provided for in the Legislative decree no. 131/1986 (which is the law governing the registration tax).

In this regard, it is to be noted that in Italy the inheritance and gift tax has been abolished. Therefore the only applicable tax in case of transferral of property is the registration tax. Yet, that does not mean that any gift is not subjected to taxation. In fact, registration tax (at rates between 1 per cent and 15 per cent) is levied on the donation of assets (other than cash and securities) to persons other than the spouse, the ascendants and the descendants and other relatives up to the fourth degree, in the value of the assets exceeding €180,759.91 (€516,456.90 if the donee is under 18 years old or disabled). On the other hand, is still important to assess whether the contribution into a trust may be regarded as a gift or not.

Under this profile, according to many scholars, the settlor does not accomplish any donation towards the trustee. The trustee is just a fiduciary person to whom is attributed the management of some assets in consequence of a plan established by the settlor. Yet, the settlor wants to carry out a donation in favour of the final beneficiaries. Such a donation will be accomplished at the end of the trust when the trustee will be obliged to conform with the trust deed. Therefore, the contribution of an asset into a trust may be regarded as an 'indirect donation'.

That seems more true if one thinks that the settlor has not any intention to benefit the trustee - and in fact the goods contributed into a trust are segregated in respect of the personal assets of the trustee - whereas the same settlor is not only willing to benefit, *medio tempore*, the beneficiaries, but also to benefit them for free.

The fiscal consequences of this interpretation are that the contribution of an asset (immovable property) from the settlor to the trustee should not be affected by any proportional taxation. This is because such a contribution is not a transfer of property in favour of