EUROPEAN TAXATION OF PASSIVE INCOME

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I INTRODUCTION

'Europe is not a natural unity, like Australia or Africa; it's the result of a long process of historical evolution and spiritual development'.[1] Prof. Dawson's opinion, although developed in a historical perspective, could be easily extended even to law in general, and taxation law in particular, without loosing anything of its value. More to the point, and under an economic perspective, the making of Europe was recently carried on in the interest of the Europeans but also taking into account the nearby countries and the more significant business partners all around the world. It wouldn't be possible otherwise to explain EC Treaty articles, such as 56, which unilaterally attribute rights to third countries individuals and legal bodies.

EU law therefore is drafted according to this basic need as well: to create a political a legal unity open to the globalised economy and to the foreign capitals. According to this assumption, the evolution of the European legal system can be observed (particularly in a taxation perspective) from two different viewpoints: one internal and another one external. Under the first one, the evolution of EU law can be seen a struggle against national prerogatives and nationalistic scepticism of some member states; while according to the second one EU law is first of all great opportunity to invest on a larger market where common rules are accepted for most of the business operation.

This is also true for European tax law, but in this specific field the harmonising process has progressively slowed down through years for reasons that I'll try to explicate in the following paragraphs. One remarkable exception in this respect is the taxation of the so-called 'passive income'.[2]

II THE UNION, THE TREATIES, THE ISSUE OF DIRECT TAXATION

National states have always been jealous of their tax sovereignty, especially when it involves direct taxes. For this reason, when the Treaty of Rome was signed in 1957, and the Communities were created, a progressive harmonisation was considered in indirect taxes such as VAT and customs duties, but not in personal income or corporate ones.

In these latter fields, the Treaty used self-restraint to foster the bilateral relations between nations, especially through double taxation conventions (DTCs).[3] In

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[1] Christopher Henry Dawson, *The making of Europe: an introduction to the History of European Unity* (3rd ed., 2003) 15.

[2] The concept of passive income is an authentic nonsense in most of the continental tax system, including the Italian one, so that is why I used the brackets. In the following paragraphs, however, I will use it in order to summarize dividends, royalties and interest payments across EU countries. Capital gains should be considered as well, but there are no EU Directives on Capital Gains Taxation so far.

[3] Treaty establishing the European Economic Community (EEC), opened for signature 25 March 1957, 298 UNTS 11, art 293 (entered into force 1 January 1958). The EEC has been renamed the

subsequent years, however, it became more and more evident that the DTCs, although fundamental, were not enough to guarantee the full free movement of capital across the Community (later, the Union) and that the remaining differences between member states could constitute a limit to foreign investments in the common market as well.

The European Court of Justice (ECJ) played (and still plays) a fundamental role in this respect. The basic idea of the case law is that, even if direct taxation is excluded from an intervention by the Council, nonetheless the fundamental freedoms enshrined in the Treaty must be respected. In other words, where a direct intervention is lacking (or is not possible), a progressive interpretation of the four freedoms and the principle of non-discrimination could be successful, although in a sort of 'second-best' approach.

In recent years, academics and practitioners have recorded an ever-increasing number of cases decided by the ECJ using the Treaty in the field of direct taxes, but despite the efforts of the ECJ, it is evident that a harmonisation of such a complex field as direct taxation can not be achieved by the judiciary, which is limited to ruling on individual cases based on specific circumstances. More to the point, it is fundamental for the business to know exactly and in advance the amount of taxes to be paid and, even more to the point, what State would legitimately exercise its taxing powers in the EU framework, and obviously this need for legal certainty does not find an adequate answer in the decision by a Court composed by judges who come from 27 different jurisdiction, representing different legal traditions and have to decide sometimes on complex controversies applying the general principles enshrined in the Treaty.

This problem was particularly evident when flows of dividends, interests and royalties were considered, because of the more volatile nature of the underlying assets (while compared to business income or profit from real estate investments) and thus also the need for a level playing field across Europe was (and still is) more urgent. In other words, cross border participations in companies are more and more frequent in Europe (just like the licences of intangible properties and financial operations) because of the progressive harmonisation of the market, that's why the taxpayers need clear and accurate rules governing these operation, in order to avoid double taxation. This explains why the Union introduced a number of directives dealing specifically with some fundamental aspects related to *passive income* taxation.

The first ones (on dividends and Merger and Acquisition - M&A - operations)[4] were implemented in 1990 and later updated and amended because of

European Community (EC) and the text of the Treaty has been changed and renumbered (now art 293 is 307) after the entry into force of the Treaty of Amsterdam on 7 May 1999 (1997) OJ C340. Consolidated versions of the Treaties can be found at (2006) OJ C321 E. All further references are to the consolidated version of the Treaties establishing the EC (the Treaty).

[4] *European Economic Communities (EEC) Council Directive No 435/1990 of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States* [1990] OJ L225, 6. The directive was subsequently amended by the *European Community (EC) Council Directive No 123/2003 of 22 December 2003 amending Directive 1990/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States* [2004] OJ L7, 41 and *European Community (EC) Council Directive No 98/2006 of 20 November 2006 adapting certain directives in the field of taxation, by reason of the accession of Bulgaria and Rumania* [2006] OJ L363, 129. *European Economic Communities (EEC) Council Directive No 434/1990 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of*

the EU accession of the new states; another one (involving interests and royalties), although drafted in the same time, was not implemented for another 13 years.[5] The aim pursued by the Commission was twofold: on one side the policymakers tried to avoid any double taxation within the European Union related to the free flow of these incomes. On the other side they indirectly offered foreign investors useful tools to optimise their investments across the continent. Even if Europe is still characterised by 27 different tax jurisdictions, the goal was to minimise such differences for those investing on assets, loans or intangibles in EU companies using EU parents established in any one of the European countries.

Unluckily, neither the text of the European Constitution signed in Rome[6] nor the thinner text drafted by the Member states in Berlin and then developed in Lisbon[7] seem to add anything interesting in this respect. Tax law is once more set aside by the European lawmakers: it could be argued that it is not considered a priority or (more likely) that it is still impossible to reach a unanimous consensus of the Member states to introduce common rules in direct taxes. This article reviews current *Eurotaxation* of passive incomes, focusing on the non-EU investor wishing to establish a subsidiary in Europe to obtain the highest return from investments in the EU.

III TREATY AND BOUNDARIES OF THE FREEDOMS: CITIZENSHIP AND RESIDENCE

The European harmonisation in direct taxation is grounded on the four freedoms[8], the principle of non-discrimination, the right of establishment and the

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shares concerning companies of different Member States [1990] OJ L225, 1. The Directive was subsequently amended by the *European Community (EC) Council Directive No 19/2005 of 17 February 2005 amending Directive 90/434/EEC of 23 July 1990 on the Common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States* [2005] OJ L58, 19 and *European Community (EC) Council Directive No 98/2006 of 20 November 2006 adapting certain directives in the field of taxation, by reason of the accession of Bulgaria and Rumania* [2006] OJ L363, 129.

[5] *European Community (EC) Council Directive No 49/2003 of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States* [2003] OJ L157, 49. The Directive was subsequently amended by *European Community (EC) Council Directive No 66/2004 of 26 April 2004 adapting various directives in the fields of free movement of goods, freedom to provide services, agriculture, transport policy, and taxation by reason of the accession of the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia* [2004] OJ L168, 35; *European Community (EC) Council Directive No 76/2004 of 29 April 2004 amending Directive 2003/49/EC as regards the possibility for certain member states to apply transitional periods for the application of a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States* [2004] OJ L157, 108; *European Community (EC) Council Directive No 98/2006 of 20 November 2006 adapting certain directives in the field of taxation, by reason of the accession of Bulgaria and Rumania* [2006] OJ L363, 129.

[6] *Treaty establishing a Constitution for Europe* open for signature 16 December 2004 [2004] OJ C310 (never entered into force). *The Treaty of Nice amending the Treaty of the European Union, the Treaties establishing the European Communities and certain related Acts* open for signature 26 February 2001 [2001] OJ C80, should also be considered. So far, however, no specific provisions involve direct taxation.

[7] *The Treaty of Lisbon amending the Treaty on European Union and the Treaty establishing the European Community* open for signature 13 December 2007 [2007] OJ C306.

[8] Namely, free movement of goods, services, persons (workers) and capitals

implementation of specific directives according to Art 94 of the Treaty:[9] free movement of persons, goods, services and capital[10] are of equal relevance, but in the light of this research the third plays a more relevant role as far as it is applicable to third countries investors as well. In this respect, while the non-discrimination principle still involves individuals and companies that are intrinsically members of the Union or there resident, it is the free movement of capital (and the freedom of establishment as well) which could arouse the interest of third countries' companies in particular.[11]

A *Free Movement of Capital*

In a Treaty written by Europeans (and for Europeans) it could be considered almost impossible to find provisions drafted also to the advantage of (or at least taking into account) third-country individuals or legal bodies. This statement is not entirely accurate.

First of all, it was already pinpointed above that the free movement of capital is clearly and positively set also to the advantage of individuals and legal bodies resident or belonging to third countries:[12] in this respect the ECJ case law is relevant for third countries as well for European ones. As was noted by prominent academics, Art 56 can be now considered 'the most advanced and far-reaching provision in the EC Treaty in the relations with third countries',[13] and the reasons of this extension towards third countries are better understood if, to a certain extent, the free movement of capital is seen as a sort of legal watchdog of the European currency, the Euro.[14]

Rather than attributing a unilateral gift to non-EU countries, allowing them a sort of free ride on one of the fundamental freedoms, the European lawmaker arguably wished to consolidate the reliability of the (future) currency and of the investment within the old continent: both inbound and outbound.[15] This is the

[9] Art 94 reads as follows: 'The Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament and the Economic and Social Committee, issue directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the common market'.

[10] In the EC Treaty: Art 12 (prohibition of discrimination), 23 (goods), 39 (workers), 43 (establishment), 49 (services), 56 (capitals and payments).

[11] The most advanced research in European tax law is arguing about the possibility of extending the free movement of services to third countries as far as the movement involves EU citizens; see Pasquale Pistone, 'The Impact of European Law on the Relations with Third Countries in the Field of Direct Taxation' (2006) *Intertax* 235.

[12] Art 56 reads as follows: '1. Within the framework of the provisions set out in this Chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited. 2. Within the framework of the provisions set out in this Chapter, all restrictions on payments between Member States and between Member States and third countries shall be prohibited'.

[13] Pistone, above n 11, 235.

[14] This of course does not mean that the provision is void of any significance for the European countries which refused the Euro currency, such as the UK, being relevant as it is to any investment in assets or financial operations.

[15] However Pistone, above n 11, 236, noted that the Advocate General Kokott (*Re Manninen* (C-319/02) [2004] ECR I-7477) seemed to limit the protection of Art 56 to the inbound investment (para 79 of the Conclusions). This interpretation is clearly inconsistent with the ratio which arguably inspired art 56 and its importance to enhance the reliability of the European currency

reason why understanding Art 56 and its limits (not present in the other freedoms) is of paramount importance for foreign investors wishing to allocate assets, participate in companies or finance them in Europe.

For the same reason, it is important to understand the case law that Art 56 brought about in the past when the effective safeguards guaranteed were benchmarked by practitioners. One of the most controversial aspects in this respect is the interaction between fundamental freedoms: it is clearly understood in case law that a very peculiar relation binds together Art 56 and Art 43, and where the latter is applicable the former is not. This mainstream interpretation actually led the ECJ to use Art 56 in a very limited set of cases, denying its relevance in each and every case when freedom of establishment was at stake.

The drawback of this approach is that as Art 43 has a narrower scope, not including third countries, the ECJ deny its protection, considering that when the circumstances of the case could fall *de facto* into Art 43 and Art 56 as well, only the first provision must be used. Furthermore, if the plaintiff is resident in a third country, then the freedom of establishment could not be used and therefore he was left without any European protection.

This ultimate consequence led many influent authors to stress the fact that in this respect EU law is not entirely coherent, because it seems to protect more (and better) the free movement of capital rather than the right of establishment. In other words, where a portfolio participation in a company, and its subsequent dismissal, would fall under the scope of Art 56, the creation of a branch or even a qualified participation in a subsidiary (granting the majority of votes, for example) would not.

These issues could be interesting not only for the protection of the participation as such, but even for the income yielded by it such as dividends or capital gains derived from the subsequent winding up of the company, or the sale of the portfolio. All in all, the problem can be summed up as follows: why EU law should protect a lesser form of investment and deny any protection to companies and individuals resident in third countries? The lack of overall coherence seems evident to the authors, who strongly criticised this outcome.

While this criticism is fundamentally right and therefore the opinion of the aforementioned authors should be supported,[16] some arguments still exist in favour of the *status quo*. Basically the current interpretation seems to rely on a finalistic (or teleological) approach that also takes into account the asymmetry[17] of the right attributed to an individual or to a company of a non-EU country.

The EU seems to encourage foreign investments and protect foreign payments in European companies, or in favour of EU established companies (or individuals as well); to this extent the basic condition is that the management of the company, its direction and the main decisions involving its business are placed in Europe. However, when a third-country investor moves into Europe with a branch, a permanent establishment or a similar device, while keeping abroad the place of effective management of the company, the situation suddenly changes

worldwide. Other reasons are clearly expressed and delineated by the previously mentioned author.

[16] This is the opinion, for instance, of Advocate General P. Wattel, as reported by Pistone, above n 11, 237.

[17] The free movement of capital protects third countries investors without any need of reciprocity in their home States in favour of EU investors.

and the protection of the Treaty decreases significantly. To this extent, the narrow interpretation of the ECJ seems to correctly balance the advantages that the EU grants for free to third countries individuals and legal bodies, or, more accurately, shows that the extension of Art 56 is not a gift at all, but rather an instrument to maximise specific investments, carefully selected, in Europe. The third-country investor must be aware that, when deciding on getting into Europe, it is not a paradox that the higher the investment, the lower the protection when the latter constitutes also an establishment of the business, falling outside Art 56.

B *The Right of Establishment*

In paragraph III A the free movement of capital was discussed on the basis that a specific provision of the Treaty (Art 56) clearly extended it to the advantage of investors resident in third countries. The issue related to the right of establishment is slightly more complex. Basically the Treaty defends the freedom establishment only so far as it is invoked by European *nationals*: however, it is still to be questioned who are European citizens.

At first glance the answer seems to be clear, given as it is by the Treaty itself. According to the fundamental text, European citizenship is embedded in the national one, in so far as a citizen of a Member State is also an EU citizen.[18] However, while in the case of individuals the answer is simple and straightforward, in the case of legal bodies and companies the definition is partially different.

The notion of citizenship in this case is linked by the Treaty to the law of a Member state (any one of them) under which the company was constituted and where it has its registered office, central administration or principal place of business.[19] According to Art 48, then, a non-EU company cannot enjoy the fundamental rights under the Treaty even if it has a permanent establishment or a subsidiary within the borders of the Union, nor if it claims that the place of effective management is European to all effects and purposes (in this latter case, however a different answer should be more appropriate *de iure condendo*[20]).

The Treaty, however, does not seem to take into account the case of transfer of the main seat of a company from a third country to an EU one such as Italy, where foreign legal bodies are recognised by Italian international private law and allowed to be managed by the state of origin corporate governance rules (not conflicting in principle with Italian ones). A teleological interpretation could allow consideration as being ‘formed in accordance’ with the rules of a Member state those companies respecting the international private law principles of the latter. If this interpretation is accepted, then a company with its registered office in an EU country, but with the central administration or principal place of business elsewhere in the world, could qualify for the benefit of the Treaty.

This is not the case with the directives mentioned above. The legislature clearly attributed the advantages of the provisions to companies formed according to any of the EU commercial laws, so far excluding companies incorporated abroad and then transferred within the EU. For this reason, a company incorporated in a third

[18] Art 19 of the Treaty.
[19] Art 48 Ibid.
[20] That is, according to law as it should be.

country (non European) will not qualify for the advantages of the directive even if it moves its legal seat within the EU.

IV DIVIDENDS *EUROTAXATION*: A PERSPECTIVE FROM ABROAD

The European directive providing for ‘a common system of taxation applicable in the case of parent companies and subsidiaries of different Member states’ was implemented in 1990 with a specific aim: to prevent double taxation on the flow of dividends running from subsidiaries to parents across Europe. It was clear that until 1990 the bilateral DTCs signed by the Member states were in most cases inadequate to the necessities of the common market, and that the cross-border nature of the dividends caused double taxation was inconsistent with the aims being pursued by the Treaty. The directive therefore tried to prevent this outcome by working on the two sides of the taxation on dividends: the possible withholding (or taxation at source) and the taxation in the home state of the parent company.

Withholding taxes on dividends are now prevented by Art 5, as introduced by Council directive 2003/123/EC; this is a straightforward rule that is applicable to the subsidiary state (this applies in most of the cases) and to the parent home state as well (Art 6). Taxation of the dividends as part of the taxable income of the parent company is still allowed, but in this case the home state must be ready to accept a tax credit equal to the amount of the corporate tax effectively levied on the business income of the subsidiary. Of course, the parent state can exempt the dividends attributed to the company, thus skipping the complexities of the credit calculation (Art 4). [21]

It could be argued, then, that the system depicted by the directive does not amount to a uniform system of dividend taxation across Europe, it is not a complex body of taxing rules individuating the taxable base, the rate applicable, etc., but rather an efficient mechanism to distribute the taxing power amongst the Member states in a way consistent with the Treaty and the needs of a harmonised common market.

So far the DTCs have been considered both insufficient (as potentially not covering all the possible flows of dividends across any EU state) and structurally inadequate (because of their intrinsic bilateral nature)[22] to provide reliable rules to the Euromarket. However, where the debate within the Union is focusing on the notions covered by the directive and its effective application,[23] the interest of a third-country investor obviously focuses on the possibility of exploiting the advantages granted and the conditions to be met to qualify under the directive.

Those possibilities are very limited so far. First of all, the directive clearly set out the qualifying subjects as companies’ resident within the EU and at the same time not resident abroad, according to a DTC between a third country and the EU state

[21] This article was amended as well by the aforementioned 2003/123/EC directive.

[22] Some exceptions do exist. This is the case, for instance, of some Nordic countries, which are experiencing a Multilateral Convention: see Marijaana Helminen, ‘Dividend, Interest and Royalties under the Nordic Multilateral Double Taxation Convention’ (2007) *IBFD Bulletin* 49.

[23] See amongst others *Bosal Holding BV v Staatssecretaris van Financiën* (C-168/01) [2003] ECR I-9409; *Océ van der Grinten v Commissioners of Inland Revenue* (C-58/01) [2003] ECR I-9809.

of the case. Secondly, the European rules clearly considers the case of the permanent establishment, but only if it belongs to another EU company.[24]

According to these conditions, the only possibility that a third country investor has to exploit the directive goes through the creation of a subsidiary, namely a sub-holding, within the territory of the Union and in conformity to the commercial law of any of the Member states.[25] The selection of the state of the case clearly depends on the withholding taxes applied to the outbound dividends paid by the resident sub-holding to the third state resident parent company. Generally the choice falls on the Netherlands, Luxembourg or Ireland, although more recently Baltic countries are raising the interest of foreign investors as preferential entrance gates to the EU.

The directive also comes with an anti-avoidance provision, possibly also relevant for investors resident in third countries: Art 1, par. 2 clearly points out that anti-abuse or anti-fraud provisions shall be in any case applicable, despite the directive, when necessary. More to the point, the directive does not introduce a European notion of abuse, but rather makes reference to the rules already in force in the various Member states.[26] Even if at first glance, especially by a non-EU observer, such a provision could seem capable of restricting significantly the scope of the directive, it must be remembered that the ECJ had always judged strictly the compatibility of anti-abuse provisions (either unilateral or deriving from a bilateral agreement) with the European directives or the Treaty as well.

To this extent, a specific anti-avoidance provision must pass several tests aimed at verifying its proportionality, reasonableness and adequacy to reach the aim pursued while minimising EU rights and freedoms. Even in the recent past, the ECJ denied the compatibility with the Treaty of general anti-abuse provisions, such as the CFC ones in the UK, as they are too general in their scope and fail to aim at the very specific cases in which such avoidance (or abuse) effectively takes place. To a certain extent, the UK CFC provisions constituted a disproportionate infringement of fundamental freedoms that was considered as unacceptable by the Court.[27]

Moreover, it is also important to remember that dividend payments could be covered by Art 56, as clarified in the former paragraph. To this extent, it could be argued that the Treaty is able to provide to investors resident in third countries better protection than the directive allows: despite the unfavourable outcome to the taxpayer, the *Holböck* case[28] would be considered a good starting point for future development of the principle.

[24] See art 2(2) as introduced by the 2003/123/EC directive. A clear reference to the permanent establishment was missing in the 1990 version, urging academics to question the analogical application of the EU provisions.

[25] The hypothesis put forward above at II (2) should be considered as purely theoretical and has never been tested by the ECJ.

[26] Ben Terra and Peter Wattel, *European Tax Law* (2005) 525.

[27] The case was decided by the ECJ under the freedom of establishment provision: the case was a purely European one with a company resident in the UK and another in Ireland (financing the first one): see Marco Greggi, 'Avoidance and *abus de droit*: the European approach in tax law' (2008) e-Journal of Tax Research Viol 6(1) 23-44). It is interesting to speculate what the outcome of the judgment would have been if a third-country company would have been involved, thus allowing a test of CFC regulations under Art 56.

[28] *Holböck v Finanzamt Salzburgland* (C-157/05) [2007] ECR I-4051; for an in-depth analysis, see Michael Lang, Joseph Schuch and Claus Staringer, *ECJ Recent Developments in Direct Taxation* (2006) 9.

V INTERESTS AND ROYALTIES: THE *BENEFICIAL OWNERSHIP* CLAUSE AND THE CONSEQUENCES ON INVESTORS AND LICENSORS RESIDENT IN THIRD COUNTRIES

The EU Commission has been working for several years on what we call today the 'Interest and Royalty directive'. The first blueprint of the Directive was presented in 1990, together with the proposal for the 'Parent–Subsidiary' and the cross border 'Merger and Acquisition' ones; however the fate of the former was the more unfortunate of the two.

The concept inspiring this directive was simple and straightforward: royalties have to be taxed only once in the European Union, and this power has to be attributed to the country of the payee (Art 1(1) of the directive). The issues the directive addresses are different from the ones in the "Parent–Subsidiary": in the case of interests and royalties, generally speaking, no double taxation occurs within the common market; while royalties are taxed upon the payee, they are at the same time generally tax deductible for the payer. The same goes for interest, even if some national limitations might occur.

The need for harmonisation was therefore less urgent, but even in this case the DTCs were considered insufficient to the common market and the administrative compliance costs connected to the payments and the compensation for the tax paid at source inconsistent with the Treaty. The preamble to the directive clearly refers to the 'burdensome administrative formalities' and 'cash flow problems' for the payee taxpayer to this extent.

Clearly, the cross-border royalty flows are not subject to international double taxation as dividends are in so many cases; more to the point, they are subject to juridical double taxation only.[29] This is due to the fact that, in most cases, royalties are a cost deductible by the payer (if the intellectual property is used for trade or business purposes), and the withholding tax, if not prevented by DTCs, is generally compensated by use of the tax credit mechanism.[30] The issue of double taxation was not therefore a priority for royalties as it was for the dividend case, and this situation can partially justify the delay of so many years in the implementation of directive 2003/49/CE.

However, while on one side the aim of the legislature was to foster the market, on the other side it was aware that in the case of royalties and interests the possibilities of improper tax planning would have been sensibly greater than in the case of dividends. As a result, the application of the directive (that is, the exclusion of any taxation at source for dividends and royalties payments) depends on two classes of anti-avoidance provisions, one being introduced directly by the EU legislator (namely, the 'beneficial owner' test) and the other one relying on the specific national rules.

The Directive uses the notion of 'beneficial owner' when dealing with the payee of royalties: basically, only the beneficial owner of royalties can qualify for the taxation at source exemption. Needless to say, the hardest part is the definition of beneficial owner in those systems (most of the continental ones) where such a

[29] While the dividends suffer also from the economical one, the distinction is clearly explained by Marijaana Helminen, *The Dividend Concept in International Tax Law* (1999) 9 and 38.

[30] Or the exemption mechanism in case the state of the payee chose this second solution in a way similar to the one in art 23B of the OECD Model.

notion simply does not exist and where the respective revenue services are almost free to shape it in the preferred way.

This objective condition of uncertainty (the ECJ has not expressed its view clearly yet) is particularly dangerous for the third-country investor who set up a sub-holding in Europe (as suggested in the former paragraph) in order to optimise his profits insofar as the sub-holding could be considered a 'non-beneficial owner" and thus disregarded for these purposes. To this extent, the only contribution possible to rely on is the interpretation of the concept in the application of the DTCs; even if the operation is not entirely correct under a purely dogmatic point of view, the concept is implemented there in the same way the EU lawmakers use it in the directive.

The authors[31] who have discussed this topic pinpoint that the notion of 'beneficial owner' comes from common law, where it was used for the first time under trust law, to distinguish between 'legal ownership' and 'beneficial ownership' of an asset. This distinction is, however, impossible according to various continental laws (for instance, according to Italian civil law);[32] therefore, the mainstream *doctrine*[33] argues that it is necessary to give the notion of 'beneficial owner' a completely different and autonomous meaning.

The text of the directive goes beyond the mere enunciation of the concept, adding that a beneficial owner is considered as such when it receives the royalty payment 'for its own benefit, and not as an intermediary such as an agent, trustee or authorised signatory, for some other person'.[34]

This approach must be followed carefully by the interpreter: to a certain extent, it could be argued, no sub-licensor would be considered a beneficial owner so far as the ultimate owner of the flow of royalties is the owner of the intangible. The same goes, *mutatis mutandis*, for the financing operations. This extremely restrictive interpretation of the provision could eventually lead to serious problems for all those third countries investors wishing to allocate their intangibles to a EU resident company using a licensing contract (behaving as a sub-licensor on the continent).

Others could argue that a sub-holding company operating as a financing entity (or as an intangible owner in conformity to a licence) could qualify as a beneficial owner as well. This requires the company to be able to demonstrate that the spread between the interest paid (to the non-EU resident holding company) and that gained by the financed company in Europe is fair, reasonable and consistent with the arm's-length principle (that is, introduces a quantitative test).
It is clear that qualifying a kind of income by using a quantitative approach is not always satisfactory under law, but in the absence of an ECJ clear position on this point and reading the text of the directive only, no other alternatives seem possible and maybe the distinction has really to rely on the differences in the amount of the

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[31] Charles Du Toit, *Beneficial Ownership of Royalties in Bilateral Tax Treaties* (1999) 99.

[32] Italy implemented legislation on trusts very recently (in 2005), adding Art 2645 *ter* to the Civil Code.

[33] Luc Hinnekens, 'European Commission introduces beneficial ownership in latest tax directive proposals adding to the confusion with regard to its meaning' (2000) *EC Tax*, 43 and 44; David Oliver, 'Beneficial ownership and OECD Model' [2001] *British Tax Review* 65; Du Toit, above n 29, 145; OECD (ed.), *Commentary to the Model Tax Convention on Income and on Capital* (2003) 173 (more to the point above at para II(4).

[34] Art 1(4).

paid royalties or interest. A purely anti-avoidance purpose[35] is attributable to two other fundamental provisions of the directive: Art 4, par. 2[36] and Art 5.

The first one includes some basic transfer pricing rules to the outgoing flows of royalties and interest: the Member State is allowed to tax at source the amount of royalties paid by the resident company (or permanent establishment) exceeding their arm's-length amount. Just as with every case involving transfer pricing, the anti-avoidance rule is applicable only if the payment involves two related parties, i.e. two associated enterprises. In the case of the directive, however, the lawmaker introduces the condition of a special relationship, saying that: 'Where, by reason of a special relationship … the amount … of royalties exceeds the amount which would have been agreed … the provisions of this directive shall apply only to the latter amount, if any' (Art 4, par. 2). It is evident that this condition goes beyond the notion of associated enterprises (or companies) asking for something more to be verified for the application of the rule above mentioned.

In fact, all the companies according to the directive conditions must be necessarily associated if they want to take advantage of the taxation at source exemption; therefore, it could be argued that every royalty or interest payment under the directive falls also within the application boundary of the arm's length anti-avoidance rule. However, no details are given about the notion of 'special' relationship, which is quite new in EU tax law.

The consequence of this choice is that every state has been free to implement the rule as it wished to do, granting the taxpayer either a more limited or a wider leeway to define the amount of royalties paid and to have it both as tax deductible on the payer and at the same time not taxed at source because shielded by the directive. This is important particularly for the third country investor, who could be pushed to establish its sub-holding company in the European country where weaker anti-avoidance provisions exist to this extent.

In the case of Italy, for example, the legislature has interpreted the notion of 'special' relationship as the one provided for by the transfer pricing rules in direct taxation.[37] Basically the relation can be considered 'special' when one company controls another one, and in this way, in Italy, the conditions to be met to apply general transfer pricing rules and the limitation to taxation at source exemption are exactly the same.

The lack of harmonisation is evident in this case because of the fact that every state shall be free to interpret differently the notion of 'special' relationship, and this situation will surely lead to different meanings of the concept in different states, with an overall level of harmonisation that will be clearly reduced. The choice of not introducing autonomous concepts and the decision to refer to the separate national legal concepts is also adopted in the case of the other anti-

[35] The time dedicated to inquiry about the nature (anti-elusive or anti-fraud or not) of a provision in the directive could seem wasted under a practically oriented approach to the text of the directive and its implication in the different national law. In the Italian experience (at least) it is, however, fundamental to allow flexible, extensive or simply literal interpretation of the words and of the concept used by the legislature. The more a provision is finalised to contrast specific operations with a tax-avoidance purpose, the more the interpretation of that provision shall be restricted to those issues enumerated by the legislature.

[36] Art 4(1) also contains anti-avoidance provisions, but they are generally limited to interest payments covered by the directive together with royalties.

[37] Art 110, Italian Direct Taxation Act, T.U. 917/86.

avoidance (and anti-fraud) rules. They have a wider margin of application in this directive than has previously occurred[38] in the history of EU tax law, probably due to the concerns of the Council about an improper use of the taxation at source exemption.

Art 5 of the text clearly points out that the directive shall not prevent the application of any national anti-avoidance provision and that the states can suspend the application of its benefits when one of the principal motives of a transaction (that is, a licensing contract, for instance) is tax avoidance. The importance of this provision is evident as far as it allows the national lawmaker to suspend the directive (and the Tax office to deny its advantages), even if tax avoidance is only one motivation amongst the many which pushed the taxpayer to sign that specific licensing contract and to pay the royalties due: tax avoidance does not need to be the only motivation or the fundamental one in the overall operation.

Even if the article under examination (Art 5) sets out no specific limitations, it is possible to say that according to the general principles of European tax law, every limitation to the impact of the directive in national law must be consistent with the principle of proportionality. There must be an acceptable proportion between the infringement committed by the taxpayer and the consequences at law provided for by the lawmaker and applied by the Tax office.

VI M&A: CAPITAL GAINS TAXATION OF EUROPEAN COMPANY REORGANISATIONS

Both M&A and the issues related to company mobility could seem to fall, at first glance, outside the scope of this article and have nothing to do with capital gains taxation. No EU directive deals specifically and directly with capital gains taxation on the continent as the above-mentioned directive 435 does with dividends and 49 with royalties and interest, respectively. The absence of directives is arguably a consequence of both on the clumsiness of the decision-making process or, less likely, on a failure to understand the problem.

Capital gains realised on cross-border operations (involving assets, real estate or whatever else) can still be taxed according to the source rules (where the asset is located at the moment of its sale) or depending on the residence ones. These two approaches, most obviously, coexist even within the tax legislation of each Member state, depending on the nature of the asset, the operation performed or other factors.

In the case of Italy, for example, capital gains on real estate are taxed in the country if the individual or the company realising them is resident for tax purposes in Italy. On the contrary, the gains realised when selling a real estate located in Italy are always taxed in the country, whatever the residence of the parties involved. However, capital gains obtained on shares sold on a stock market are not taxed in Italy if realised by a non-resident investor. Similar rules are in force in various other continental countries, leading eventually to some cases of double taxation and others of double non-taxation, depending on the specific circumstances of the case. The first ones are resolved according to any applicable

[38] Excluding perhaps art 1(2) of the "Parent–Subsidiary" directive 1990/435/EEC.

DTC, while the others are tackled by national legislation as well, in most of the cases.

Despite the issues involved or the problems that could arise, the EU legislator was not able to rule about that, except for some specific cases: those involving company reorganisations (namely M&A operations) and the transfer of the seat of a specific company (the *Societas europaea*).

Basically, all M&A operations could determine capital gains as the difference between the book value of the assets involved and their market value at the moment of the operations (of the merger, for instance). The different tax legislation of the two countries involved could tax the gains according to different regulations, and, despite all this, the mere fact of considering an M&A operation an occasion to tax the accrued but not yet realised capital gains could constitute *per se* a limit on the implementation of such operations across the continent. This is the kind of issue that directive 1990/434/EEC addresses.[39]

The EU legislature decided to qualify these kinds of operations as tax irrelevant, that is, no capital gains are deemed to be realised upon the implementation of such extraordinary corporate operations. Art 4 of the directive clearly set the rule applicable, deciding that an operation falling into the list in Art 1 does not give rise to any taxation on capital gains calculated as a difference between the real value of the assets (i.e. market value) transferred and their value for tax purposes.

However, even in this case the EU lawmaker clearly limited the applications of these provisions, using a different set of rules focusing on purely EU companies: that is, companies incorporated and resident for tax purposes within the EU. The annex to the directive, in clarification of Art 3(a), introduces a list of specific companies qualifying for the advantages of the directive and, subject to detailed conditions, capable of merging with others (or acquire them) in a tax- free system. These are the only circumstances where the EU provides a harmonised system of taxation of capital gains, or, in other words, the only case where the gains are not taxed at all.

The consequences of the implementation of this directive for third-country companies and investors are of less relevance. These economic subjects are excluded from the neutrality regime set up by directive 434 for the obvious reason of their non-EU condition. At the moment, a different solution seems impossible for the EU deliberately chose to limit the positive effects of the directive (that is the tax neutrality of the operation) to EU incorporated companies only, thus implicitly excluding the third countries companies even if they have they legal seat within the EU.

The only remark of some interest is, however, the one related to the mobility of the company within and outside the EU (intra-EU mobility and outbound mobility). Recently both the ECJ and the Commission have debated the issue of the transfer of the seat of one company from one Member State to another and, it could be argued, from the EU to a third country.

In this respect, the ECJ already ruled that most of the exit taxes that applied in these circumstances in the first hypothesis (intra-EU mobility of individuals) are against the freedom of establishment and Art 43 of the Treaty. The Commission added that in its point of view the same rule should be extended

[39] Art 1(a) of the directive rules that is applied to ‘mergers, divisions, partial divisions, transfers of assets and exchanges of shares in which companies of two or more Member States are involved’.

to companies as well in cases of transfer of the seat from one Member State to another.

Companies resident in third countries should not underestimate the importance of these remarks. Should the Commission succeed in upholding its thesis in front of the ECJ, then possibly Art 56 of the Treaty would be full applicable to non-EU taxpayers as well: the conflict of a European exit tax with the free movement of capital in case a company participated in by a non-EU investor decides to move abroad could lead to a decision of the ECJ in favour of the foreign (non-EU) investor wishing to move the participated company away from the EU. Even if it is too early to raise such a question to practitioners and the more likely answer by now could be the one deciding in favour of the compatibility of such taxes with the free movement of capital, the remarks raised and the problem to be solved seem all but ill founded, at least considering the most likely evolution of the EU law in the next years.

VII CONCLUDING REMARKS

It is not easy to draw conclusion while dealing with a topic that is subject to continuous changes with the passing of months[40]. The academic who begin this task could easily feel like the artist in 'The Draughtsman's contract' by Peter Greenaway: the scenario to be represented seems still but yet something differs day after day, and in the portrait there is always something misplaced or pointing at a hidden truth that lies beneath the appearance. Those who have seen the movie know that it is not wise for the painter (or for the author) to finalise the work, but as far as this paper deals with taxes only, some concluding remarks are possible, and hopefully riskless.

Passive income taxation in Europe is today regulated by a number of provisions that find their sources in the EC Treaty, in directives, in cases decided by the ECJ and in other European sources of law. For some specific third countries[41], taxation of passive income is regulated also by peculiar agreements (Treaties) signed by the Union as such with them, pursuing the implementation of the 2003/48/EC Council Directive (the so called 'Savings directive').

The complexity of the sources of law is mirrored by the provision applicable to each kind of income: basically speaking, the EU gives priority to the taxing right of the state of residence, following closely the OECD approach in this respect, with the notable exception of the dividends, that are taxes where the subsidiary is placed (more to the point, an exemption is applied upon the parent company for almost the entire amount of them). The same goes for capital gains: where statutory regulations lack, the case law is applied; according to an ever increasing number of precedents the ECJ is aware of the unacceptable consequences of double taxation and of the tact that DTCs do not provide an adequate protection for that (the case of exit taxes, that generally are not covered by the treaties is a clear example in this respect). However, the priority in this case seems to be given to the inbound state.

Europe is not a federal state and probably will never be, despite the advantages that could derive form this final stage of the Community political

[40] For instance the recent *Cartesio Oktató és Szolgáltató bt v Hungary* (C-210/06) [2008] dated December 16th 2008.

[41] Switzerland, San Marino, Andorra, Principality of Monaco, and Liechtenstein.

evolution: the awkward process of the European Constitution ratification is paradigmatic in this respect. Nonetheless much has already been done for what regards taxation law. The pattern of the above mentioned directives and cases created a sort of chessboard on which European (and foreign) investors can (reasonably) easily understand what is taxed, where and how much. For the latter category of taxpayers, Art 56 of the Treaty is still the most efficient shield to be used against the national tax authority of the case while trying to defend the investment or the income realized from a discriminatory of disproportionate taxation. It is a sort of back door from which the non-EU taxpayer can step into the common European house: hopefully, not Greenaway's Compton House.