ECJ Decides Dutch Capital Tax Levy Incompatible with EC Law

The European Court of Justice (ECJ) issued its decision in the Senior Engineering Investments case (C-494/03) on 12 January 2006, concluding that the Dutch capital tax is incompatible with EC law, specifically the capital tax directive. The case concerned a direct informal capital contribution by a U.K. parent company to its German sub-subsidiary. The Dutch tax inspector was of the opinion that the Netherlands was entitled to levy capital tax at the level of the Dutch intermediary company.

Capital Tax Directive

Directive 69/335 and amendments thereto aim to eliminate restrictions within the EU on the raising of capital, including shareholder contributions of capital to companies. The directive, therefore, harmonizes the levy of capital tax throughout the EU and sets rules, amongst others, on which transactions capital tax may be levied. Based on the directive, Member States are also entitled to abolish capital duty.

Facts of the Case

Senior Engineering Investments involves an international group of companies, whose U.K. parent company (Senior Ltd) held all the shares of a Dutch intermediary company (Senior BV). Senior BV, in turn, was the parent company of a German subsidiary (Senior GmbH). Senior Ltd made a direct informal capital contribution to Senior GmbH. However, since Germany abolished its capital tax, no capital duty was levied on this transaction in Germany.

The Dutch tax inspector was of the opinion that the Netherlands also was entitled to levy capital tax because the direct informal capital contribution by Senior Ltd to Senior GmbH increased the capital of Senior BV as well. According to the tax inspector, there were two taxable transactions: a contribution of capital to the intermediate company and one contribution to the sub-subsidiary. Additionally, it was argued that the levy of capital tax on the capital increase in the Dutch intermediary company was justified because Germany did not tax the capital increase at the level of the company that actually received the capital contribution.

The Dutch intermediary company was of the opinion that the levy of capital tax constituted an infringement of EC law, and more specifically the capital tax directive, so it initiated a refund procedure. Ultimately, the Dutch Supreme Court referred the case to the ECJ for a preliminary ruling.

ECJ Decision

The ECJ opined that capital duty is to be levied on the company receiving the capital contribution, unless the recipient cannot be deemed to be the real beneficiary of the contribution. In any event, capital duty can be levied only once.

The ECJ had to determine which company was subject to capital duty. The ECJ concluded that since the capital contribution led to an increase in the capital of Senior GmbH (the German sub-subsidiary), it qualified as a taxable transaction under the capital tax directive. Consequently, the receiving company, Senior GmbH, is in principle subject to capital duty on the capital
contribution in Germany. However, since Germany no longer levies capital tax, the informal capital contribution will not be taxed at all.

The Court held that simply because no capital tax is levied does not justify the imposition of capital tax by the Netherlands at the level of the intermediary company. The informal capital contribution by the parent company in its sub-subsidiary results in only one taxable transaction. Germany’s decision not to levy capital tax does not justify a Dutch levy. Furthermore, the recipient of the contribution is normally the company that actually receives the resources or services; instances where this is not the case are exceptional and, it is only in such cases where it would be necessary to identify the “real recipient” of the resources. Although the informal capital contribution by the ultimate parent to its sub-subsidiary might also lead to an increase in the capital of an intermediary company, this is not a separate taxable transaction, but a consequence of the direct informal capital contribution to the sub-subsidiary. There is no new taxable event. Based thereon, the Court concluded that levying capital tax is not permitted under the directive.

Further, the ECJ concluded that the capital tax directive does not allow a Member State to benefit (and increase its tax revenue) from the fiscal moderation of another Member State. Each Member State has sovereignty to levy capital tax within the boundaries of the directive. One Member State must respect the decision of another to abolish capital tax and not levy any compensating taxation to nullify this advantage.

Possible Consequences

It should be noted that some Member States make the tax treatment of certain transactions dependent on the tax treatment in the other Member State. For example, under specific anti-abuse rules in the Netherlands, the deduction of interest in certain transactions (i.e. transactions that convert equity into debt within a group) depends on the effective tax rate at the level of the creditor. If the effective taxation is not sufficiently high according to Dutch standards, the interest deduction is disallowed, unless the taxpayer demonstrates that the transaction has a sound business purpose. The compensating taxation test is a safe harbor. In a domestic Dutch context, the same transactions are taxed more favorably, even in the absence of a sound business purpose, since the creditor will normally meet the requirement that the interest income be taxed sufficiently. It could be argued that this compensating taxation test conflicts with the freedom of capital movement, because the Netherlands should respect the tax system of the other state. The Senior case provides additional support for this argument.

Although the Dutch capital tax has been abolished as of 1 January 2006, the Senior case remains relevant for past years and with respect to the levy of capital taxes in other Member States.

If you have any questions concerning the items in this publication, please contact one of our EU tax professionals:

<table>
<thead>
<tr>
<th>Name</th>
<th>Email</th>
<th>Phone</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hans van den Hurk</td>
<td><a href="mailto:hvandenhurk@deloitte.nl">hvandenhurk@deloitte.nl</a></td>
<td>+31 (40) 234 5511</td>
</tr>
<tr>
<td>Anno Rainer</td>
<td><a href="mailto:arainer@deloitte.com">arainer@deloitte.com</a></td>
<td>+32 (02) 600 6716</td>
</tr>
<tr>
<td>Jan Roels</td>
<td><a href="mailto:jroels@deloitte.com">jroels@deloitte.com</a></td>
<td>+32 (02) 600 6709</td>
</tr>
<tr>
<td>Otmar Thoemmes</td>
<td><a href="mailto:othoemmes@deloitte.de">othoemmes@deloitte.de</a></td>
<td>+49 (892) 90368804</td>
</tr>
<tr>
<td>Eric Tomsett</td>
<td><a href="mailto:etomsett@deloitte.co.uk">etomsett@deloitte.co.uk</a></td>
<td>+44 (207) 007 0899</td>
</tr>
<tr>
<td>Gerben Weening</td>
<td><a href="mailto:gweening@deloitte.nl">gweening@deloitte.nl</a></td>
<td>+31 (40) 234 5502</td>
</tr>
<tr>
<td>Jasper Korving</td>
<td><a href="mailto:jkorving@deloitte.nl">jkorving@deloitte.nl</a></td>
<td>+31 (40) 2345 501</td>
</tr>
</tbody>
</table>
EU Tax Alert

For general inquiries contact:
DTTGlobalTax@deloitte.com  +44 (207) 007 0120

Be sure to visit us at our Web site: www.deloitte.com/tax

This material has been prepared by professionals in the member firms of Deloitte Touche Tohmatsu. It is intended as a general guide only, and its application to specific situations will depend on the particular circumstances involved. Accordingly, we recommend that readers seek appropriate professional advice regarding any particular problems that they encounter. This information should not be relied upon as a substitute for such advice. While all reasonable attempts have been made to ensure that the information contained herein is accurate, Deloitte Touche Tohmatsu accepts no responsibility for any errors or omissions it may contain whether caused by negligence or otherwise, or for any losses, however caused, sustained by any person that relies upon it.

Deloitte refers to one or more of Deloitte Touche Tohmatsu, a Swiss Verein, its member firms, and their respective subsidiaries and affiliates. As a Swiss Verein (association), neither Deloitte Touche Tohmatsu nor any of its member firms has any liability for each other’s acts or omissions. Each of the member firms is a separate and independent legal entity operating under the names “Deloitte,” “Deloitte & Touche,” “Deloitte Touche Tohmatsu,” or other related names. Services are provided by the member firms or their subsidiaries or affiliates and not by the Deloitte Touche Tohmatsu Verein.

© 2006 Deloitte Touche Tohmatsu. All rights reserved.